Commonwealth of Pennsylvania
State Employes' Retirement System
1994
ANNUAL FINANCIAL REPORT

Including the Report of Independent Accountants on Financial Statements for the years ended December 31, 1993 and 1992

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CHAIRMAN

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May 1995

Honorable Tom Ridge, Governor
Commonwealth of Pennsylvania

Members, Pennsylvania General Assembly
Members, Pennsylvania State Employes' Retirement System

Dear Governor Ridge, Legislators and Members:

The Board of Trustees of the Pennsylvania State Employes' Retirement System (SERS) is pleased to present our Annual Financial Report, which reviews operations and investments of the SERS Fund for 1994.

The SERS Board and staff are committed to three primary goals: 1) meeting the Fund's pension commitments to all SERS annuitants and their beneficiaries; 2) providing counseling and retirement-related services to our approximately 195,000 active and retired members; and 3) the prudent management of Fund assets.

The SERS Fund had a total market value at December 31, 1994, of $13.2 billion and had a -1.1% annual investment rate of return for 1994. By contrast, our average annual investment rate of return for the past 10-year and five-year periods was 11.2% and 8.3%, respectively. These long term high average returns were key factors in SERS's achieving fully-funded status in 1992 and in maintaining it through 1994.

Rest assured that I and the SERS Board and staff will continue to pursue prudent investment strategies to assure the solvency of the Fund and the quality of pension-related services to all SERS members.

Sincerely,

Nicholas J. Maiale
SERS Board Chairman

Table of Contents

INTRODUCTION

SERS Board Members and Administrative Support *ii*

Mission Statement *iv*

Investment Policy *v*

Investment Objectives *vi*

SECTION I

Investment Highlights 1

Summary of Investment Program 2

Summary of Pennsylvania Investments 18

SECTION II

Investment Performance and Actual Statistics 29

Prudent Person, Market Value and Asset Allocation 31

Investment Advisors 36

Commissions 39

Demographics/Fund Growth 40

Deferred Compensation Program 41

SECTION III

Report of Independent Accountants 45

SERS Board Members

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Honorable Anthony B. Andrezeski
State Senator

Honorable Gibson E. Armstrong
State Senator

Honorable Robert A. Bittenbender
State Secretary of the Budget to Governor Ridge

James W. Brown, Esq.
Financial Consultant

Mr. Edward J. Keller
Executive Director, AFSCME

Honorable Catherine Baker Knoll
State Treasurer
(Henry V. Sciortino, Treasurer's Representative)

Mr. Charles J. Lieberth
Retired Member and Former Secretary of Labor and Industry

Honorable Edward J. Lucyk
State Representative

Mr. K. Paul Muench
Budget Analyst
House Majority Appropriations Committee

Honorable Joseph R. Pitts *(to 1995)*
State Representative

Honorable Jere L. Strittmatter *(1995)*
State Representative

SERS Administrative Staff

John Brosius
Executive Director

Dale H. Everhart
Assistant Executive Director

Peter M. Gilbert
Chief Investment Officer

Investment Office Staff
Joseph A. Braccia
Erica C. Bushner
David J. Kalman
Karen N. Nicely
Diane Sterthous

Francis J. Donlevy
Director of Financial Management

Bruce Feldman
Counsel-in-Charge

Geoffrey S. Yuda
Information Officer

Investment Consultants

RogersCasey & Associates
(Investments)

Cambridge Associates
(Venture Capital and Alternative Investments)

Actuary
Hay/Huggins Company, Inc.

The Townsend Group
(Real Estate)

Hamilton Lane
(Specialty Consultant)

Agent Bank, Trust Accounting Services, and Securities Lending Agent
State Street Bank

Independent Auditor
Coopers & Lybrand

SERS Mission

I. PLAN ADMINISTRATION: To administer the retirement benefits plan for state employes and elected officials in accordance with Pennsylvania statutes

II. MEMBER SERVICES: To provide effective services to all active and retired members

III. MANAGEMENT OF RETIREMENT FUND ASSETS: To accumulate, manage and disburse the retirement Fund assets in accordance with fiduciary standards and at a reasonable cost to Commonwealth taxpayers

IV. INVESTMENT POLICY: To maximize investment returns while exercising a prudent person investment policy

Investment Policy

The State Employes' Retirement Board adopted a formal Statement of Investment Policy in 1979 which has been revised to reflect and incorporate legislative changes governing investments.

The purpose of the Statement is to formalize the Board's investment objectives, policies, and procedures, to establish guidelines for the investment of the assets of the Fund, and to define the duties and responsibilities of the various entities involved in the investment process.

The major elements of the Statement are:

- As fiduciaries, the Board will exercise that degree of judgment, skill, and care under the circumstances then prevailing which persons of prudence, discretion, and intelligence, who are familiar with such matters, exercise in the management of their own affairs in investment matters;

- The Fund's overall investment objective is to provide a total rate of return, over full economic cycles, which exceeds the return of a fully diversified market portfolio within each asset class. The Board seeks to meet this objective within acceptable risk parameters through adherence to a policy of diversification of investments by type, industry, quality, and geographic location;

- The Board employs an Investment Staff and also contracts with investment advisors and consultants to provide expert, professional judgment in all investment decisions;

- An annual Investment Plan is prepared to control the allocation of funds during the year among investment advisors and categories of assets;

- Guidelines are established for each category of assets used by the Fund's investment advisors to provide a framework for monitoring quality, diversification, and liquidity; and

- Where investment characteristics, including yield, risk, and liquidity, are equivalent, the Board's policy favors investments which have a positive impact on the economy of Pennsylvania.

Investment Objectives

To assure an adequate accumulation of reserves in the Fund at the least cost to the citizens of the Commonwealth and to provide some protection against the erosion of principal by inflation, the long term investment objectives of the Fund, are:

A. Achieve and maintain the State Employes' Retirement Fund in excess of Accrued Benefit Liability;

B. Over the long run, achieve a positive real total rate of return (with inflation measured by the GDP Implicit Price Deflator);

C. Over the long run, achieve an absolute total rate of return not less than the actuarial investment return assumption;

D. Achieve in Domestic Stocks a total return that exceeds the total return of the Wilshire 5000 Index;

E. Achieve in International Stocks a total return that exceeds the total return of the SERS Custom International Stock Index;

F. Achieve in the Fixed Income asset class a total return that exceeds the total return of the SERS Fixed Income Custom Index;

G. Achieve in the Equity Real Estate asset class a total return that exceeds the total return of the Russell/NCREIF Index;

H. Achieve in the Cash asset class a total return that exceeds the total return on U.S. Treasury Bills (90 days);

I. To achieve in the Venture Capital asset class a risk-adjusted total return, net of fees, that exceeds either the Venture Economics' relevant Vintage Year Median Returns or relevant return data furnished for benchmark purposes by SERS's Venture Capital/Alternative Investments consultant;

J. To achieve in the Alternative Investments asset class a risk-adjusted total return, net of fees, that exceeds either market returns for similar types of alternative investments, or relevant return data furnished for benchmark purposes by SERS's Venture Capital/Alternative Investments consultant.

Total return includes income and both realized and unrealized gains and losses and is computed on market value.

The Board seeks to meet these objectives within acceptable risk parameters through adherence to a policy of diversification of investments by type, industry, investment manager style, and geographic location.

SECTION I

Summary of SERS Investment Program
December 31 1994

The assets of the State Employes' Retirement System (SERS) are administered by the SERS Board of Trustees. The Board has adopted an Investment Policy that incorporates the provisions of the Retirement Code which govern the investment of SERS's assets. The Policy provides investment objectives and guidelines. An Investment Plan is reviewed and updated annually for strategic asset allocation purposes, as well as for diversification needs within each asset class.

Market Value as of 12/31/94: SERS's assets had a market value of $13,222.9 million on 12/31/94.

SERS Asset Allocation ($ in millions)

Asset Class	Market Value*		1994 Investment Plan Long Term Target Allocation	Specially Designed Portfolios PA Market Value	Total PA Market Value
Domestic Stocks	$ 5,662.8	42.8%	41.0%	$ 64.5	$331.0
International Stocks	1,274.1	9.6	10.0		
Fixed Income	4,109.0	31.1	29.0	319.7	411.2
Cash	248.3	1.9	2.0		
Tactical Asset Allocation	706.5	5.3	5.0		13.3
Real Estate	988.5	7.5	9.0	184.8	190.3
Venture Capital	115.5	0.9	2.0	115.5	115.5
Alternative Investments	118.4	0.9	2.0	10.1	10.1
Total	$13,222.9	100%	100%	$694.6	$1,071.4

** Numbers may not add due to rounding.*

Investment Highlights

The unaudited market value of the State Employes' Retirement System (SERS) investments including accruals, was $13,222.9 million as of December 31, 1994. This represented a decrease of $426.8 million from the $13,649.7 million market value as of December 31, 1993. The decrease was due to net unfavorable changes in asset market values and from SERS's negative cash flow situation, as employer and employe contributions were below benefit and administrative payments. Based on market value of assets as of September 30, 1994, SERS is the 24th largest public pension fund in the nation and the 39th largest public and corporate pension fund.

For the year ended December 31, 1994, SERS realized a -1.1% total investment rate of return after fees. The Fund achieved in equity securities a -0.9% total return compared to the -0.2% total return of the Wilshire 5000 Index. The Fund achieved in fixed income a -2.1% total return compared to the -4.1% total return of the SERS Custom Bond Index. As a long-term investor with long-term liabilities, the Fund is most concerned with long-term performance. SERS's annualized 10-year investment rate of return was 11.2%, and the annualized five-year investment rate of return was 8.3%.

SERS invests in seven asset classes and uses external investment advisors with various investment styles as a method to ensure overall fund diversification. As of December 31, 1994, the asset class allocation was: 52.4% stocks; 31.1% fixed income; 7.5% real estate; 5.3% tactical asset allocation (TAA); 1.9% cash; 0.9% venture capital; and 0.9% alternative investments. As of December 31, 1994, SERS had retained the services of 78 external investment advisors to manage 100 portfolios.

As of December 31, 1994, SERS had $1,071.4 million, approximately 8.1% of SERS's total Fund, invested in Pennsylvania. Of this amount, SERS had placed over $694.6 million in portfolios which were specially designed for Pennsylvania investment. The Pennsylvania portfolios include: two stock accounts; a private placement long term loan account; a mortgage portfolio (which includes conventional commercial, FHA projects, and residential properties); several real estate portfolios; 23 venture capital limited partnerships; and one LBO limited partnership.

Number of Investment Advisors: SERS had 78 external investment advisors to manage portfolios.

- 12 Domestic Stock investment advisors
- 7 International Stock investment advisors
- 1 Tactical Asset Allocation investment advisor
- 10 Fixed Income investment advisors
- 2 Cash investment advisors
- 16 Real Estate investment advisors
- 17 Venture Capital limited partnership managing general partners
- 13 Alternative Investment limited partnership managing general partners

In addition, one Domestic Stock investment advisor was approved by the Board.

Number of Investment Portfolios: SERS had 100 investment portfolios/accounts

- 17 Domestic Stock portfolios
- 7 International Stock portfolios
- 1 Tactical Asset Allocation portfolio
- 11 Fixed Income portfolios
- 3 Cash portfolios
- 24 Real Estate portfolios
- 23 Venture Capital limited partnership interests
- 14 Alternative Investment limited partnerships

In addition, one Domestic Stock portfolio and one Alternative Investment partnership were approved by the Board. Several investment advisors manage multiple portfolios for SERS.

Summary of SERS Domestic Stock Investments
December 31, 1994

Domestic and International Stocks comprise the Stock asset class. Stocks is one of seven major asset classes which SERS uses to diversify the investment of the Fund. SERS investment plan diversifies stock investments and balances stock management styles. SERS contracts with external investment advisors to manage portfolios.

Policy:
Stock investments are employed by the Fund primarily because their expected large return premiums versus inflation will, if realized, help preserve and enhance the real value of the Fund over long periods of time. The Stock asset class is to be managed on a total return basis.

Stock investments shall emphasize, but not be limited to, publicly traded securities which provide SERS with an equity interest in private sector concerns (e.g., common stock, preferred stock, convertible preferred stock, convertible bonds, etc.). Specific investment guidelines are established for each investment advisor in the Stock asset class that are consistent with this goal and with the advisor's specific mandate on behalf of SERS.

SERS long term investment objective in the Domestic Stock component of the Stock asset class is to achieve a risk-adjusted total return, net of fees, that exceeds the total return of the Wilshire 5000 Index.

SERS 1994 Investment Plan allocated 41.0% of assets to Domestic Stocks. It targeted the investment of 70% of Domestic Stocks in large capitalization stocks and 30% in medium/small capitalization stocks, and provided for a balance in value and growth investment styles. The 1994 Plan targeted 50% of Domestic Stocks to be indexed.

Market Value as of 12/31/94:
Domestic Stocks had a $5,662.8 million market value, 42.8% of the total fund's $13,222.9 million market value on 12/31/94.

Number of Investment Advisors:
SERS had contracts with 12 external investment advisors to manage Domestic Stock portfolios. One additional investment advisor for the Domestic Stock area was also approved by the Board.

Number of Investment Portfolios:
SERS had 17 Domestic Stock portfolios managed by the 12 investment advisors. One additional portfolio for the Domestic Stock area was also approved by the Board.

Type of Investment Portfolios:
As of 12/31/94, 70.6% of SERS Domestic Stock allocation was in large capitalization stock strategies and 29.4% was in medium/small capitalization stock strategies. The portfolios within the Domestic Stock area can be classified by investment style: value - 18.9%, growth - 22.7%, and core - 58.4%. SERS had 13 actively managed portfolios (43.8% of Domestic Stocks) and four passively managed index portfolios (56.2% of Domestic Stocks).

	Domestic Stock Investment Advisor	Investment Style	*Market Value of Portfolio as of 12/31/94 ($ millions)
	Arnhold and S. Bleichroeder Capital	medium cap value stocks ($160 million to be funded in 1995)	
1.	Barrow, Hanley, Mewhinney & Strauss	large cap value stocks	$604.8
2.	Dietche & Field Advisers	med/small cap value stocks	62.3
3	Emerald Advisors	PA growth stocks	19.6
4.	Mellon Equity Associates - PA Index	PA med/small cap stocks - indexed	4.8
	Mellon Equity Associates - PA stocks	PA stocks - structured core	40.0
	Mellon Equity Associates - Special Equity	med/small cap stocks - structured core	432.1
5.	Miller, Anderson & Sherrerd	large cap growth stocks - structured	284.1
6.	Neuberger & Berman	med/small cap value stocks	63.0
7.	Pilgrim, Baxter & Associates	med/small cap growth stocks	230.9
8.	Provident Investment Counsel (PIC)	large cap growth stocks	345.0
	PIC Stellar Fund	small cap growth stocks	49.0
9.	Sturdivant & Co.	large cap value stocks	9.6
10.	Trinity Investment Management	large cap value stocks - structured	328.8
11.	Wells Fargo Nikko Investment Advisors Equity Index Fund (S&P 500)	large cap stocks - indexed core	2,064.2
	Extended Equity Fund (Wilshire 4500)	med/small cap stocks - indexed core	764.3
	Equity Growth Fund	large cap growth stocks - indexed	352.0
12.	Zevenbergen Capital	large cap growth stocks	8.3
	Total		$5,662.8

** Includes stocks and cash which the manager had available for investment. Numbers may not add due to rounding.*

Summary of SERS International Stock Investments
December 31, 1994

International and Domestic Stocks comprise the Stock asset class. Stocks is one of seven major asset classes which SERS uses to diversify the investment of the Fund. SERS investment plan diversifies stock investments and balances stock management styles. SERS contracts with external investment advisors to manage portfolios.

Policy:
Stock investments are employed by the Fund primarily because their expected large return premiums versus inflation will, if realized, help preserve and enhance the real value of the Fund over long periods of time. The Stock asset class is to be managed on a total return basis.

Stock investments shall emphasize, but not be limited to, publicly traded securities which provide SERS with an equity interest in private sector concerns (e.g., common stock, preferred stock, convertible preferred stock, convertible bonds, etc.). Specific investment guidelines are established for each investment advisor in the Stock asset class that are consistent with this goal and with the advisor's specific mandate on behalf of SERS.

SERS long term investment objective in the International Stock component of the Stock asset class is to achieve a risk-adjusted total return, net of fees, that exceeds the total return of the SERS International Stock Custom Index.

SERS 1994 Investment Plan allocated 10.0% of assets to International Stocks. It targeted the investment of 80% of International Stocks to large capitalization stock strategies and 20% to medium/small capitalization stock strategies.

Market Value as of 12/31/94:
International Stocks had a $1,274.1 million market value, 9.6% of the total fund's $13,222.9 million market value on 12/31/94.

Number of Investment Advisors:
SERS had contracts with seven external investment advisors to manage International Stock portfolios.

Number of Investment Portfolios:
SERS had seven stock portfolios managed by the seven investment advisors in the International Stock area.

Type of Investment Portfolios:
As of 12/31/94, 78.8% of SERS International Stock allocation was in large capitalization stock strategies and 21.2% was in medium/small capitalization stock strategies. All seven portfolios in the International Stock area are actively managed.

	International Stock Investment Advisor	Investment Style	*Market Value of Portfolio as of ($ millions)
1.	BEA Associates	international stocks - core	$196.5
2.	Dunedin Fund Managers	international med/small cap stocks	134.5
3.	Miller, Anderson & Sherrerd	international stocks - core	388.4
4.	Morgan Grenfell Investment Services	European stocks	103.3
5.	Scudder, Stevens & Clark	Pacific basin stocks	116.6
6.	Seligman Henderson	international med/small cap stocks	136.3
7.	Templeton Investment Counsel	international stocks - core	198.6
	Total		$1,274.1

* *Includes stocks and cash which the manager had available for investment. Numbers may not add due to rounding.*

Summary of SERS Fixed Income Investments
December 31, 1994

Fixed Income is one of seven major asset classes which SERS uses to diversify the investment of the Fund. The SERS's Investment Plan diversifies Fixed Income investments and balances Fixed Income management styles. It is SERS's practice to contract with external investment advisors to manage portfolios.

Policy:
In the Fixed Income asset class, SERS's long term investment objective is to achieve a risk-adjusted total return, net of fees, that exceeds the total return of the SERS Fixed Income Custom Index. This Custom Index is composed of the following four Lehman Brothers' indices:

20% Lehman Intermediate Government Index;
30% Lehman Long Term Government Index;
25% Lehman Corporate Bond Index; and
25% Lehman Mortgage-Backed Securities Index

SERS's 1994 Investment Plan targeted an eventual allocation of 29% of assets to the Fixed Income asset class. Of this amount, 75% was targeted to active strategies, and 25% to passive strategies. The asset class is further classified according to core and specialty strategies, with 67% targeted to the core segment and 33% to the specialty segment. Specialty strategies include:

- whole-loan mortgages, with an approximate target weight of 17.4% of total Fixed Income;
- high yield/special credits, with an approximate target weight of 13.8% of total Fixed Income; and
- private placements, with an approximate target weight of 2.7% of total Fixed Income.

Market Value as of 12/31/94:
Fixed Income had a $4,109.0 million market value, 31.1% of the total Fund's $13,222.9 million market value, on 12/31/94.

Number of Investment Advisors:
SERS had contracts with 10 external investment advisors to manage portfolios within the Fixed Income asset class as of 12/31/94.

Number of Investment Portfolios:
SERS had a total of 11 portfolios within the Fixed Income asset class.

Type of Investment Portfolios:
The Fixed Income asset class is divided into core and specialty segments. Core portfolios utilize a broad array of fixed income securities, while specialty portfolios focus on well-defined sectors and opportunistic strategies within the fixed income market.

Core
SERS had 4 actively managed core bond portfolios with a market value of $1,792.5 million (43.6% of Fixed Income), and one passively managed core bond portfolio with a market value of $921.4 million (22.4% of Fixed Income).

Specialty
SERS had one whole-loan mortgage portfolio with a market value of $714.6 million (17.4% of Fixed Income), three high yield/special credits portfolios with a market value of $568.8 million (13.8% of Fixed Income), and two private placement portfolios with a market value of $111.6 million (2.7% of Fixed Income).

	Fixed Income Investment Advisor	Investment Style	*Market Value of Portfolio as of ($ millions)
1.	P.G. Corbin Asset Management	active domestic fixed income	$8.1
2.	J.P. Morgan Investment Management	active domestic fixed income	407.2
3.	Mellon Bond Associates	indexed	921.4
4.	Miller, Anderson & Sherrerd	active domestic /global fixed income	1,369.6
5.	Smith Graham & Co.	active domestic fixed income	7.6
	Specialty		
6.	Cigna Investments	PA private placements	1.5
7.	John Hancock Mutual Life Insurance	privately placed fixed income	110.1
8.	W. R. Huff Asset Management	high yield bonds	521.4
9.	Legg Mason Real Estate Advisors	residential and commercial mortgages	714.6
10.	Trust Company of the West Special Credits Fund IIb	special credits	18.9
	Trust Company of the West Special Credits Fund III	special credits	28.5
	Total		$4,109.0

* *Includes securities and cash that the manager had available for investment. Numbers may not add due to rounding.*

Summary of SERS Cash Investments
December 31, 1994

Cash is one of seven major asset classes which SERS uses to diversify the investment of the Fund. The SERS's Investment Plan diversifies Cash investments and balances Cash management styles. It is SERS's practice to contract with external investment advisors to manage portfolios.

Policy:
In the Cash asset class, SERS's long term investment objective is to achieve a risk-adjusted total return, net of fees, that exceeds the total return on 91 day U.S. Treasury Bills. SERS's 1994 Investment Plan targeted an eventual allocation of 2% of assets to the Cash asset class.

Market Value as of 12/31/94:
Cash had a $248.3 million market value, 1.9% of the total Fund's $13,222.9 million market value.

Number of Investment Advisors:
SERS had a contract with one external investment advisor to manage a portfolio within the Cash asset class. SERS also utilizes the Pennsylvania State Treasury Department to manage two cash accounts.

Number of Investment Portfolios:
SERS had three portfolios within the Cash asset class: one managed by the external advisor, and two managed by the Pennsylvania State Treasury Department.

Type of Investment Portfolios:
SERS had one actively managed short duration fixed income portfolio with a market value of $164.3 million (66.2% of Cash); on a combined basis, the two portfolios managed by State Treasury had a market value of $84.0 million (33.8% of Cash). State Treasury also manages excess cash balances held by other SERS investment advisors in other asset classes. In the aggregate, State Treasury managed $381.9 million on behalf of SERS and SERS's external investment advisors as of 12/31/94.

Cash Investment Advisor	Investment Style	Market Value of Portfolio as of 12/31/94 ($ millions)*
1. Payden & Rygel	Short duration fixed income and money market instruments. Portfolio duration may not exceed 4 years.	$164.3
2. PA State Treasury Department		$84.0
Separate Account	Short duration fixed income and money market instruments. Portfolio duration may not exceed 4 years.	
Short-Term Investment Pool **	Short term fixed income and money market instruments. Maximum maturity of individual securities cannot exceed 2 years. A 10% "basket clause" may be employed under the Fiscal Code.	
Total		$248.3

** Numbers may not add due to rounding. ** Market value does not include cash maintained in the Short Term Investment Pool by SERS's other external investment advisors. In the aggregate, State Treasury managed $381.9 million on behalf of SERS and SERS's external investment advisors as of December 31, 1994.*

Summary of SERS Tactical Asset Allocation Investment
December 31, 1994

Tactical asset allocation (TAA) is one of seven major asset classes which SERS uses to diversify the investment of the Fund. It is SERS practice to contract with external investment advisors to manage portfolios.

Currently, the TAA asset class contains one investment strategy -- the Enhanced 70/30 Normal U.S. Tactical Asset Allocation ("Enhanced 70/30 TAA"). The Enhanced 70/30 TAA strategy shifts assets among stocks, bonds and cash. SERS contracts with an external investment advisor, Wells Fargo Nikko Investment Advisors ("Wells Fargo Nikko"), to manage the portfolio.

Policy:
SERS 1994 Investment Plan targeted an eventual allocation of 5.0% of assets to the TAA asset class.

Market Value as of 12/31/94:
SERS investment in the Wells Fargo Nikko Enhanced 70/30 TAA Fund had a $706.5 million market value, 5.3% of SERS total fund's $13,222.9 million market value on 12/31/94.

Number of Investment Advisors:
SERS had a contract with one external investment advisor to manage a TAA portfolio.

Number of Investment Portfolios:
SERS had one TAA portfolio managed by the one investment advisor.

Type of Investment Portfolio:
The Wells Fargo Nikko Enhanced 70/30 TAA Fund seeks above-market returns from a portfolio diversified among the domestic stock, fixed income, and cash markets.

The Fund invests in three of Wells Fargo Nikko's collective funds (Equity Index Fund D, Long-Term Fixed Income Fund C, and the Short-Term Asset Allocation Cash Fund). Proprietary technology is used to establish the optimal asset mix among these funds, and adjust the mix of these funds. The mix will vary as economic and capital market conditions change. Under equilibrium conditions, the Enhanced 70/30 TAA Fund will have 70% of assets invested in the Equity Index Fund, 30% of assets invested in the Long Term Income Fund, and 0% in the Cash Fund. As of 12/31/94, the actual asset mix of the Fund was 40% stock, 60% bonds, and 0% cash.

Summary of SERS Real Estate Investments
December 31, 1994

Equity Real Estate is one of seven major asset classes which SERS uses to diversify the investment of the Fund. SERS's investment plan diversifies Real Estate investments and balances Real Estate management styles. In accordance with the plan, SERS contracts with external investment advisors to manage portfolios.

Policy:
In the Equity Real Estate asset class, SERS's long term investment objective is to achieve a risk-adjusted total return, net of fees, that exceeds the total return of the Russell/NCREIF Index. SERS's 1994 Investment Plan targeted an eventual allocation of 9% of assets to the Equity Real Estate asset class. Investments are made through pooled fund investments and separate account portfolios where SERS owns the properties directly or with other co-investors. SERS's Equity Real Estate portfolio guidelines provide for diversification by:

- Transaction structures
- Property types
- Geographic location
- Development phase

20% of SERS's Equity Real Estate investments are located in Pennsylvania.

Market Value as of 12/31/94:
Real Estate had a $988.5 million market value, 7.5% of the total fund's $13,222.9 million market value, on 12/31/94.

Number of Investment Advisors:
SERS had contracts with 16 external investment advisors to manage Real Estate portfolios.

Number of Investment Portfolios:
SERS had investments in 24 Real Estate portfolios managed by the 16 investment advisors.

Type of Investment Portfolios:
As of 12/31/94, the composition of the Real Estate portfolio was:

- 80% equity ownership, 20% equity-oriented mortgages
- 44.1% pooled funds, 55.8% separate accounts
- 26% office, 6% industrial, 39% retail, 20% residential, 2% hotel/motel, 7% other
- 20% Pennsylvania, 24% East excl. PA, 22% West, 17% South, 17% Midwest
- 33% of market value of the separate accounts invested in ten properties located in Pennsylvania.

Real Estate Investment Advisor	SERS Initial Funding	Property Type	Transaction Structure	Market Value of Portfolio as of 12/31/94 ($ in millions)*
1. Aetna				
CERESA I	6/30/83	office, industrial	equity ownership	$7.2
PMSA	9/30/83	diversified	equity oriented mtgs.	38.6
RESA	6/30/84	diversified	equity ownership	26.9
Apartment Fund	12/31/86	residential	equity ownership	10.7
2. Alex Brown Profile Fund	12/31/84	office, industrial retail, residential	equity ownership	18.2
LaSalle				
Separate Account	10/1/93	diversified	equity ownership	25.8
3. Copley CIIF-II	8/8/88	industrial, other	equity ownership	12.2
4. Corporate Property Investors	12/8/83	office, industrial retail	equity ownership	109.7
5. Forest Investment Assoc.	10/30/92	timber	equity ownership	35.3
6. Heitman				
Separate account	12/28/87	office, industrial retail	equity ownership	175.3
California Land Venture	12/7/89	land	equity ownership	10.4
7. JMB				
Separate account	11/16/87	office, industrial retail, residential	equity ownership	267.1
JMB Group Trust III	12/31/84	office, retail	equity ownership	38.1
8. John Hancock Apartment Fund	9/30/86	residential	equity ownership	13.0
9. Metric				
MIAF	9/5/89	residential	equity ownership	23.5
MIAF II	12/7/92	residential	equity ownership	23.0
10. Prudential				
PRACE I	12/31/83	office, industrial	equity ownership	3.3
PRACE II	12/31/84	industrial, residential	equity ownership	6.1
11. PSI III	8/16/88	industrial	equity ownership	17.4
12. Sentinel Corp.	7/31/84	office, industrial retail, residential	equity ownership	33.3
13. Lowe Enterprises	10/1/93	diversified	equity ownership	48.3
14. Radnor Advisers	10/1/93	PA diversified	equity ownership	.15
15. Whitehall V & VI	4/20/94	Opportunistic	equity and debt	20.1
16. TCW Fund VI	4/20/94	Opportunistic	equity and debt	24.6
Total				$ 988.5

* *Numbers may not add due to rounding.*

Summary of SERS Venture Capital Investments
December 31, 1994

Venture Capital is one of seven major asset classes which SERS uses to diversify the investments of the Fund. Venture Capital is the financing of young, relatively small, rapidly growing companies that do not have access to public equity or debt-oriented institutional funding. SERS invests capital as a limited partner in venture capital limited partnerships which are established for the purpose of investing in and managing venture capital companies.

Policy:
In the Venture Capital asset class, SERS's long term investment objective is to achieve a risk-adjusted total return, net of fees, that exceeds either the Venture Economics' relevant Vintage Year Median Returns or relevant return data furnished for benchmark purposes by SERS's Venture Capital consultant. SERS's 1994 Investment Plan targeted an eventual allocation of 2.0% of assets to the Venture Capital asset class.

History:
Act 95, Section 4, became effective on June 29, 1984, specifying that SERS may invest up to 1% of the Fund's assets in venture capital by acquiring equity or debt and equity interests in a business which is expected to grow substantially in the future. Act 23 of 1991 became effective on August 5, 1991, and amended Act 95 by specifying that SERS may invest up to 2% of the Fund in venture capital. Furthermore, Act 29 of 1994 became effective on April 29, 1994, which enabled SERS to invest according to "Prudent Person" standards, and further specified that an investment in venture capital by SERS can be made only if the investment is reasonably likely to enhance the general welfare of the Commonwealth and its citizens.

Market Value as of 12/31/94:
SERS's Venture Capital investments had a $115.5 million market value, 0.9% of the total fund's $13,222.9 million market value, on 12/31/94. In addition, SERS had $155.4 million in outstanding obligations to fund venture capital partnerships which represent 1.2% of SERS Total Fund at 12/31/94. Therefore, as of 12/31/94, the combined market value of SERS actual venture capital investments and future obligations to fund such investments equaled $255.8 million, or approximately 2.0% of SERS total Fund.

Number of Limited Partnerships:
SERS has made commitments to 23 venture capital limited partnerships. As of 12/31/94, SERS had paid in capital as a limited partner in all 23 limited partnerships. Paid in capital represents funds which have been drawn down by the venture capitalist and are readily available for investment.

SERS Venture Capital Program:
SERS Venture Capital program includes commitments to 23 venture capital limited partnerships. These partnerships are committed to include Pennsylvania-based companies as a part of their venture investment focus. The intent of these partnerships as a part of their overall venture program is to make venture capital investments in companies either headquartered in Pennsylvania or in companies which provide employment for Pennsylvania citizens. As of 12/31/94, SERS's venture capital limited partnerships have invested approximately 43% of their portfolios in Pennsylvania companies since inception. A major component of the Venture program is to diversify company investments across industries. As of 9/30/94, the Venture Capital program is well diversified across various industry categories:

1%	advanced materials	17%	biotechnology	24%	computer related industries
25%	health care related industries	7%	telecommunications	2%	electronic products
1%	retailing	1%	transportation services	1%	energy
9%	financial services	4%	industrial products	1%	environmental
1%	restaurants	2%	media services	4%	consumer products

The Venture program's financing stage focus varies: 15 of the limited partnerships have a diversified financing stage focus; two of the funds are focused on middle and later stage financing; five are focused on seed and early stage financing; and one partnership intends to make diversified stage financing available to minority-owned enterprises.

SERS Venture Capital Committed, Drawn and Distributed
At December 31, 1994

The capital committed column represents SERS capital committed to each venture capital limited partnership. Capital drawn is that portion of SERS capital commitments which was drawn or taken down by the venture capitalist and is readily available for investment. The market value of distributions column shows the value of the distributions made from each limited partnership to SERS at the time of the transaction.

Limited Partnership	Financing Stage Focus	SERS Initial Funding	Capital Committed ($ millions)	Capital Drawn ($ millions)	Distributions ($ millions)
1. Advent VII	Diversified	7/30/93	$25.0	$10.0	$0.0
2. APA/Fostin	Diversified	9/30/87	$20.0	$20.0	$16.2
3. APA/Fostin II	Diversified	6/2/93	$30.0	$9.6	$0.0
4. Bachow III	Diversified	11/9/94	$25.0	$1.0	$0.0
5. CEO Ventures S	Diversified	7/29/87	$1.0	$1.0	$0.5
6. CEO Ventures II	Diversified	7/14/89	$7.5	$7.5	$0.5
7. Edison Ventures III	Diversified	3/1/94	$25.0	$5.0	$0.0
8. Fairview Capital	Minority	9/28/94	$10.0	$0.5	$0.0
9. Fostin Capital	Diversified	11/25/85	$10.0	$10.0	$4.5
10. Fostin Capital II	Diversified	10/5/89	$7.5	$7.5	$0.8
11. Grotech PA III	Diversified	6/29/90	$3.0	$3.0	$0.4
12. Grotech PA IV	Diversified	11/1/93	$25.0	$5.5	$0.0
13. Healthcare Venture III	Diversified	7/9/92	$15.0	$12.1	$0.0
14. Keystone II	Middle/Later	11/25/85	$10.0	$10.0	$16.7
15. Keystone IV	Middle/Later	7/21/93	$15.0	$5.8	$0.7
16. NEA VI	Early/Later	3/2/94	$25.0	$6.3	$0.2
17. NEPA Venture	Seed/Early	8/29/85	$2.0	$2.0	$2.0
18. NEPA Venture-II	Seed/Early	7/24/92	$7.5	$3.8	$0.0
19. Pittsburgh Seed Fund	Seed	1/13/87	$2.0	$2.0	$0.0
20. Point Ventures	Diversified	10/2/90	$1.0	$1.0	$0.0
21. PNC Ventures I	Diversified	11/25/85	$5.0	$5.0	$7.1
22. TDH II	Diversified	11/25/85	$9.0	$9.0	$12.7
23. Zero Stage II	Seed	4/30/87	$2.0	$2.0	$0.0
Total			$282.5	$139.4	$62.4

Summary of SERS Alternative Investments
December 31, 1994

Alternative Investments is one of seven major asset classes which SERS uses to diversify the investments of the Fund. SERS's Alternative Investment program has commitments to nine leveraged buyout partnership investments, three European venture capital/private equity partnership investments, two special situations/restructuring fund partnership investments, and one partnership which specializes in private equity buyout investments while incorporating an Employee Stock Ownership Plan (ESOP) in its acquisition strategy.

Leveraged buyouts (LBO) involve acquiring companies using borrowed funds. Usually, the target company's assets serve as security for loans taken out by the acquirer. The acquirer repays the loans from cash flow of the acquired company. SERS invests as a limited partner in LBO partnerships formed for the purpose of providing funds, usually in the form of equity interests, for the acquisition of companies.

Special situations/restructuring investments operate under a philosophy of flexibility to adapt to market fluctuations and opportunities which exist from the deleveraging of debt-laden companies. Investments are usually made in successful companies which carry high debt levels and seek to deleverage for a variety of reasons. Deleveraging is often used in an attempt to avoid a major restructuring or bankruptcy. Investments are usually "white squire" or friendly "influence block" in nature. A "white squire" invests in companies which could benefit from the capital and presence of a large and supportive shareholder.

SERS is also a limited partner in three European-based venture capital limited partnerships which are focused on private equity investing in France, Germany, and the U.K. Unlike venture capital investing in the United States, venture investing within Europe is private equity in nature, tends to occur at a much later stage and concentrates on lower technology industries.

Policy:
In the Alternative Investments asset class, SERS's long term investment objective is to achieve a risk-adjusted total return, net of fees, that exceeds either market returns for similar types of alternative investments, or relevant return data furnished for benchmark purposes by SERS's Alternative Investments consultant. The 1994 Investment Plan targeted an eventual allocation of 2% to the Alternative Investments asset class.

Market Value as of 12/31/94:
SERS's Alternative Investments program had a $118.4 million market value, or 0.9% of the total fund's $13,222.9 million market value, on 12/31/94. In total, SERS had committed to invest $320 million in the Alternative Investments asset class.

Alternative Investments Program:
The Alternative Investments program has commitments to ten buyout oriented partnerships; one is Pennsylvania focused, two are Midwest focused, one is focused in the West, one is global in nature, and four are nationally focused. All are focused on small-to-medium capitalization companies. Only "friendly" acquisitions are pursued. All deals are non-hostile, privately negotiated, non-auction and completed with present management in place. SERS's special situations/restructuring partnerships are nationally focused and can invest in small-to-large capitalization companies.

SERS's acquisition/buyout partnership, which utilizes an Employee Stock Ownership Plan (ESOP) strategy, makes only friendly acquisitions that are supported by a broad group of the company's management which

invariably participates in the equity investment. Ownership is further expanded to other employees in the organization through the implementation of an ESOP. Employing an ESOP strategy gives employees a sense of ownership and a financial stake in their company.

SERS's European venture capital investments are comprised of private equity investment in companies based in the U.K. and Europe. The three partnerships focus on the U.K., France, Germany, and German-speaking countries. All three funds plan to take advantage of changes occurring within Europe, including the elimination of a number of trade barriers in the European economic community, the reunification of Germany and the disintegration of the former Soviet Union. European venture capital investing focuses on small, rapidly growing companies which do not have access to traditional sources of capital.

SERS has committed to a partnership which specializes in distressed debt instruments by investing in debt obligations of financially distressed companies with a view toward converting debt into equity. Debt is converted into equity in order to obtain an equity oriented return. The partnership is national in focus.

SERS most recent commitment was made to a current manager in the portfolio, Hellman & Friedman Capital Partners III. This partnership will continue to specialize in investments both domestically and internationally including restructurings, friendly investments in public and private companies, leveraged buyouts, and investments in undervalued situations.

SERS Alternative Investments Committed, Drawn and Distributed

The capital committed column represents SERS capital committed to each limited partnership. Capital drawn is that portion of SERS capital commitments which was drawn or taken down by the general partner and is readily available for investment. The distributions column shows the value of the distributions made from each limited partnership to SERS.

	Alternative Investments Limited Partnership	Geographic Focus	SERS Initial Funding	Capital Committed ($ millions)	Capital Drawn ($ millions)	Distributions ($ millions)
1.	APA Capital Risque III	France	11/29/90	$5.0	$3.9	$0.3
2.	APA German Ventures	Germany	1/30/91	$5.0	$2.4	$0.0
3.	Blackstone Capital II	Global	8/26/94	$40.0	$1.2	$0.1
4.	Brentwood Buyout Fund	National	11/21/88	$10.0	$10.0	$1.2
5.	Charterhouse Equity II	National & PA	3/30/94	$40.0	$16.8	$0.0
6.	CHS	Midwest & PA	9/28/89	$10.0	$9.0	$12.6
7.	CHS II	Midwest & PA	7/12/94	$20.0	$3.8	$0.0
8.	Hellman & Friedman II	National	1/7/92	$25.0	$22.2	$6.0
9.	Hellman & Friedman III	National	*	$50.0	$0.0	$0.0
10.	Kelso KIA V	National & PA	1/26/94	$40.0	$9.5	$2.5
11.	Madison Dearborn	National	2/23/93	$15.0	$6.3	$0.5
12.	Murphy & Fauver	National	10/11/88	$5.0	$5.0	$1.4
13.	RR& Z PA Fund #1	PA	3/2/88	$10.0	$10.0	$1.0
14.	Schroder Ventures UK III	UK	8/29/89	$10.0	$6.0	$2.4
15.	TCW Special Credits V	National	8/25/94	$35.0	$15.8	$0.3
	Total			$320.0	$121.9	$28.2

* *No contract to date.*

Summary of SERS Pennsylvania Investments
December 31, 1994

Members of the State Employes' Retirement Board (Board), employees of SERS and agents of the Board stand in a fiduciary relationship to the members of the System regarding the investments and disbursements of the Fund. Subject to restrictions on investments contained in the Retirement Code and the Fiscal Code, the Board has exclusive control and management of the Fund and full power to invest the assets of the Fund. The Board adopted a formal Statement of Investment Policy in 1979 which has been revised to reflect and incorporate subsequent legislative changes governing investments. Where investment characteristics including yield, risk and liquidity are equivalent, the Board's policy favors investments which have a positive impact on the economy of Pennsylvania.

SERS investment portfolios have always had substantial investments in Pennsylvania firms, as some large national firms are headquartered in the Pittsburgh, Philadelphia and Harrisburg areas, including Bell Atlantic, Rite Aid, Westinghouse, Sun, Rohm & Haas, and H. J. Heinz. In addition, SERS has invested in portfolios that are designed to give emphasis to investments in Pennsylvania. As of December 31, 1994, SERS had $1,071.4 million (approximately 8.1% of SERS total fund) invested in Pennsylvania. Of this amount, SERS had placed $694.6 million in portfolios which were specially designed for Pennsylvania investments.

Stocks

SERS has two Pennsylvania equity portfolios which increase exposure to "in-state" corporations. SERS Pennsylvania stock universe is composed of 544 publicly-traded corporations which: 1) name their headquarters as Pennsylvania and have Pennsylvania employees or operations; or 2) have Pennsylvania-based employment exceeding 25% of total corporate employment. Emerald Advisers, Inc. of Lancaster and Mellon Equity Associates of Pittsburgh actively manage portfolios for SERS from SERS Pennsylvania stock universe. The market value of SERS Pennsylvania equity portfolios were $64.5 million as of December 31, 1994.

The following are some of the top performing Pennsylvania stocks for 1994:

Company	Location	1994 Total Return
• Electronics, Missiles and Communications	White Haven	917%

The company is the world's largest producer of transmitters for the wireless cable industry.

• Numerex Corp.	Media	561%

The company was formed as a "blind pool" company in 1991.

• Fore Systems	Warrendale	321%

The company is a leader in the design, development, manufacture and sale of high performance networking products based on asynchronous transfer mode (ATM) technology.

• C-Cor Electronics	State College	244%

The company manufactures electronic equipment used in cable television and data communication systems.

- II VI Inc. Saxonburg 147%
  The company manufactures infrared materials and optical element systems for high-power lasers and low-light-level imaging and night-vision devices.

- Scott Paper Co. Philadelphia 70%
  The company is the world's largest manufacturer and marketer of sanitary tissue paper products.

- Horsehead Resource Development Co. Palmerton 66%
  A leader in the processing of industrial waste such as processing of waste from steel making operations.

- CDI Corp. Philadelphia 59%
  The firm is involved in the recruitment and hiring of technical personnel for temporary employment chiefly for the auto, chemical, and aerospace industries.

- Rite Aid Corp. Harrisburg 52%
  The largest drug store chain in the U.S. (based on number of stores); located primarily in the eastern U.S.

In addition to the Pennsylvania equity portfolios, SERS had $266.5 million invested in the 544 Pennsylvania stock universe companies as of December 31, 1994. These stocks were held in SERS index funds and by SERS actively managed portfolios.

Fixed Income

As of December 31, 1994, SERS had $1.5 million invested in loans of the Pennsylvania Private Placement Separate Account which was designed by the Pennsylvania MILRITE Council and is managed by Cigna. The purpose of these investments was to provide long-term, fixed rate loans to established Pennsylvania firms that do not have access to the public bond markets.

SERS had $334.2 million invested in Pennsylvania mortgages ($305.9 million in conventional commercial, and $12.3 million in residential properties) as of 12/31/94. The residential segment of this portfolio is comprised of competitive rate mortgages that are distributed solely throughout Pennsylvania, in accordance with SERS policy to originate 100% of all residential mortgages within the Commonwealth. The commercial segment listed above is comprised of competitive rate mortgages on various industrial, retail, apartment and office complexes within Pennsylvania. Legg Mason, SERS mortgage advisor, has committed on a best efforts basis under its fiduciary responsibility to invest between 15% and 30% of the SERS commercial mortgage portfolio in Pennsylvania-based mortgages and 100% of all residential mortgages in Pennsylvania. It is conservatively estimated that as of 12/31/94, the various commercial projects financed within the Commonwealth by SERS under the commercial mortgage program directly employ over 5,000 workers; this figure does not take into account those who are employed in the property management and maintenance areas of these projects, nor does it consider the favorable "ripple effect" that such jobs may have on the local economy.

Examples of some Pennsylvania commercial mortgages in the SERS portfolio include the following:

- Super Rite Foods Warehouse - SERS provided $20.0 million in financing for this modern warehouse and distribution center located near Harrisburg.

- Townline Apartments - SERS provided $13.4 million in financing for this apartment complex located in Blue Bell. This loan was originated in November 1993.

- Hanover Square Shopping Center - SERS provided $14.0 million in financing for this newly-constructed shopping center located in Hanover. The lead anchor store is Wal-Mart, the nation's leading retailer.

Additionally, SERS had approximately $93 million invested as of December 31, 1994, in corporate securities issued by Pennsylvania-based companies; these securities are held in SERS's various externally-managed bond portfolios.

Cash

SERS is one of the largest investors in the Short Term Investment Pool managed by the Pennsylvania State Treasury Department. Although exact figures are unavailable, the Treasury Investment Pool has significant holdings of 1) certificates of deposit issued by Pennsylvania-based financial institutions, 2) short-term notes and commercial paper issued by Pennsylvania-based companies, 3) notes and obligations of selected Pennsylvania state agencies, and 4) FNMA mortgage-backed securities backed by loans issued under the Homestart program. The Homestart program is designed to encourage home ownership within the Commonwealth by making mortgages available to lower, moderate, and middle-income Pennsylvania households.

Real Estate

In 1987 SERS began investing directly in the Pennsylvania commercial real estate market and established two separate account real estate portfolios which are managed by Heitman Advisory Corporation and JMB Institutional Realty. To date, these managers have committed to invest approximately 50% of their initial allocation in Pennsylvania properties. As of December 31, 1994, these two portfolios have invested in ten Pennsylvania properties with a net market value of $177.7 million out of a total portfolio market value of $442.4 million. In addition, in the first quarter of 1994 SERS hired Radnor Advisers of Philadelphia and provided them with an initial allocation of $25 million (subsequently increased to $50 million) to be used exclusively for PA investments.

As of December 31, 1994, the SERS real estate portfolio contained 23 Pennsylvania investments totaling 6,714,000 square feet of office, retail, hotel, apartment and warehouse space. The gross market value of these investments totaled $458 million, of which SERS's ownership share was $190 million. The portfolio contains several notable Pennsylvania real estate investments:

- Foster Plaza - This is a 10 building office park located on the main corridor from the airport to downtown Pittsburgh. The total project contains approximately 600,000 s.f. of prime office space.

- 1818 Market Street - This is a 950,000 s.f. office building in downtown Philadelphia which was purchased in 1988. During 1991 a major renovation of the building was completed which transformed the property from a Class B building to a Class A building. This $10 million renovation, in addition to improving the quality of the investment, was one of the largest construction projects in Philadelphia during that year. This renovation should position the building to take full advantage of the office market recovery.

- Heartland Properties - This is a combination of four bulk warehouse projects located in both Reading and Harrisburg. The buildings contain 868,000 s.f. of space and have excellent access to both the PA Turnpike and state interstate highways to serve Pennsylvania businesses effectively.

- York Galleria - SERS owns a significant interest in this 767,000 s.f. regional shopping mall in York, which has become the dominant mall in the area since its 1990 completion. This mall contains four major retailers and numerous other national retail chains which has created many jobs for local citizens.

- 30 N. Third Street - SERS owns a 100% interest in this major downtown Harrisburg office building which contains 190,000 s.f. The building will serve as both an investment for SERS and as SERS's headquarters in addition to providing office space for other businesses with operations in the city.

- Rockville Square Outlet Center - Through a commingled fund, SERS owns a major interest in an equity participating loan on this 420,000 s.f. outlet center in Lancaster, PA. Proceeds of our loan were used by the owner to complete a major expansion of this highly successful retail center.

- Mount Airy Resort - Through an investment partnership SERS purchased the bank debt, at a significant discount to face value, of three hotel resorts collectively known as Mount Airy Resort containing 877 rooms in the Poconos.

Venture Capital

The SERS venture capital program has committed $282.5 million to 23 venture capital partnership funds. As a part of its focus, the program targets partnerships which plan to make investments in companies either based in Pennsylvania or in companies which employ Pennsylvania citizens. These partnerships are diversified among various geographic regions and financing stages (including four seed funds designated by the Ben Franklin Partnership). SERS, in conjunction with the Pennsylvania Public School Employes' Retirement System (PSERS), created the APA/Fostin Pennsylvania Venture Capital Fund in 1987 with a commitment of $20 million from each fund. The partnership of Alan Patricof Associates/Fostin Capital manages this venture capital fund with offices in Philadelphia and Pittsburgh. During 1992, SERS and PSERS committed $30 million each, to create APA/Fostin Pennsylvania Venture Capital Fund II. With the establishment of this second fund, APA/Fostin will continue its focus on Pennsylvania venture capital investing.

A key aspect of the SERS venture capital program is the attraction of national funds into Pennsylvania investments. Alan Patricof Associates' expertise as the lead investor in the majority of their investments continues to provide Pennsylvania with a flow of venture capital money from numerous out-of-state funds and investors. The progress of Pennsylvania within the national venture capital community should reap substantial rewards in future years for both Pennsylvania and the SERS fund. As of September 30, 1994, SERS venture capital partnerships have attracted over $280 million of out-of-state funds to finance their active venture companies based in Pennsylvania.

The SERS venture program, after more than nine years of venture investing, continues to enhance the pool of venture capital available to Pennsylvania-based companies by attracting larger national venture capital funds into the state. The committed capital and managerial talent of these organizations could substantially increase business creation and job opportunities throughout Pennsylvania. These national firms also bring investment capital reserves to Pennsylvania and provide a significant opportunity for SERS to leverage its venture capital dollars while promoting economic growth.

SERS has been active in seed and early stage financings of Pennsylvania-based companies. SERS's investment in NEPA Venture Fund has, during its nine year history, provided investments in 23 Pennsylvania-based startup companies which possess a technology orientation. SERS's commitment to NEPA Venture Fund II will enable NEPA to cover the Pittsburgh area in addition to Eastern Pennsylvania. The goal of NEPA Venture Fund II will be to invest over the next five years in up to five startup companies within the Pittsburgh area.

The limited partnerships funded by SERS have made investments in 61 Pennsylvania companies which are currently active within their portfolio as of September 30, 1994. The Pennsylvania portfolio companies plus non Pennsylvania-based companies employ approximately 4,800 Pennsylvanians and have an estimated 1995 payroll of $150 million. As of December 31, 1994, $127.1 million of the $282.5 million committed to venture capital partnership funds had been drawn down for investment by the partnerships, and $57.6 million had been returned to SERS.

The following companies are examples of Pennsylvania venture capital investments funded by SERS's venture capital partnerships:

- Metallized Paper Corporation of America - This McKeesport-based company is an example of a startup manufacturing company which was founded with seed money from the APA/Fostin Pennsylvania Fund. The company manufactures products for the decorative packaging industry. In addition to the initial round of seed financing, the company has attracted over $23 million in investment capital including $7 million in equity from outside the State. This new, state-of-the-art production facility employs a recently-trained workforce of 70 Pennsylvanians from the McKeesport area. This investment is a classic example of a public/private partnership of low interest loans, incentive programs and opportunistic venture capital working together to form a new company in an economically depressed area.

- Zynaxis - Philadelphia is ranked number three in the nation in terms of attracting biotechnology startup companies. Zynaxis is a Malvern, Pennsylvania biotechnology company formed in 1988 with the help of $9.7 million in venture backing including Grotech Partners, another SERS venture manager. This company, which focuses on research related to the delivery and retention of therapeutic drugs, went public during 1992, resulting in $23.8 million in net proceeds to this startup company. Since its inception, this Grotech portfolio company has generated $27 million of capital for this Pennsylvania-based business.

- Plaid Holdings - This Baltimore-based company is a good example of how the Commonwealth benefits from investments made in other states. Plaid is the second largest manufacturer of men's tailored clothing in North America. Plaid is the largest private employer in Franklin County with a payroll of 1,100 people.

- InSoft - Develops and markets desktop video software products that integrates real-time, multipoint audio and video conferencing using networked personal computers. The Company was founded in 1991 by two former AMP employees with capital from family and friends. Since that time, InSoft has raised $1,118,000 from Edison Ventures and $2.3 million from APA/Fos II Pennsylvania Fund. Both fund managers have committed to additional funding of InSoft. Furthermore, non-PA venture capital raised for InSoft through 9/30/94 is over $4.5 million. Both the founders and SERS managers have been successful in keeping the company located in Mechanicsburg, PA, and in recruiting top technical professionals to relocate to South Central Pennsylvania. InSoft now employs 36, with a PA payroll of $1.4 million. Revenues are estimated to be $10 million for 1995.

- Ansys (formerly Swanson Analysis Systems) - This Houston, PA (30 miles south of Pittsburgh) company is a leading designer and producer of computer aided engineering software. SERS investment manager, TA Associates, goal is to add sales and marketing expertise to aid the company in further growth. As of September 30, 1994, the Company has 183 Pennsylvania employees and a PA payroll of $10 million. This single investment represents over 37% of SERS $25 million funding of Advent VII (TA Associates) and illustrates the ability of leverage by larger national managers to direct out-of-state funds to PA based companies.

- Symphony Pharmaceuticals - Along with Fostin Capital, SR One and Euclid Partners, provided $2.25 million in startup financing for Symphony in the fall of 1992. Symphony is developing therapeutics to address diseases like stroke, anxiety, and depression using proprietary technology developed by the company's CEO and scientists at the NIH. The venture financing has been leveraged with significant research support from the NIH and the University of Pennsylvania. Symphony is expected to have a product enter clinical trials by 1995. The company, which was founded at the Philadelphia University Science Center, has established offices in Malvern.

- Fore Systems - Founded by four researchers from Carnegie Mellon University, Fore Systems is a leading provider of ATM (Asynchronous Transfer Mode) networking products. ATM is fast becoming an international standard for networks that must support high speed data, voice, and video services. The company, which is based in Pittsburgh, was funded by its founders until the APA/Fostin Pennsylvania Fund led a $5 million financing in 1992. Fore has subsequently gone IPO in May 1994 at a price of $16.00 per share, raising $36 million for the Company, and has traded as high as $78 per share before a 2-for-1 stock split on February 16th of this year. The Company is the worldwide leader in the design, development and manufacture of ATM technology and is the industry exporting leader deriving 40 percent of its revenues from exports. Net revenue for the nine months ended December 31, 1994 were over $48 million, an increase of 255% over 1993's revenues. Pennsylvania employment during 1993-1994 has grown from 55 to 258 and 1995 PA payroll should be approximately $17 million.

- Mothers Work - With a headquarters and manufacturing facility based in the garment district of Philadelphia, Mothers Work is the premier manufacturer and retailer of upscale maternity clothing in the country. With 165 stores based in 25 states, the company brings in nearly $60 million per year in taxable revenue to Pennsylvania. With its first institutional funding (in 1987) coming from SERS venture manager Keystone Venture Capital, Mothers Work went public on 3/16/93 in a highly successful $18 million public offering. Employment has doubled at Mothers Work during the 1993-1994 period to 240 Pennsylvania residents at its 8 state locations with PA payroll now at $6.4 million. Mothers Work also has doubled employment of dedicated sub-contractors to 200 firms in the depressed garment district.

- U.S. Dining - Based in Norristown, this restaurant chain operates 8 restaurants (7 in Pennsylvania) under the name "Rib-it". Backed by SERS venture manager Keystone Venture Capital, the company has revenue of nearly $12 million and employs 450 Pennsylvania residents. During the 2nd quarter of 1994, U.S. Dining has become the Mid-Atlantic franchisee for East Side Marios, a moderately priced Italian restaurant owned by PepsiCo (other franchises owned by PepsiCo are KFC, Pizza Hut and Taco Bell). Its U.S. Dining's "sister" company, U.S. Restaurants, also backed by Keystone Venture Capital (but not in a SERS venture fund), employs over 3,100 Pennsylvania residents at 58 Pennsylvania restaurants.

- Turtle Beach Systems - Based in York, Turtle Beach is a pioneer in the fast-growing multimedia PC computing field. Its digital audio products include the first plug-in sound card with CD-quality sound. NEPA Venture Fund provided $600,000 of start-up financing to Turtle Beach in 1991 and 1992. The company was acquired in July 1993 by Valley Forge, PA-based Integrated Circuit Systems, Inc., a $75

million company which was backed by Keystone Venture Capital some years ago. NEPA received ICS stock and cash totaling approximately four times its investment cost

- Leonard Medical - LMI is a Huntingdon Valley-based company which is developing endoscopic surgical instrumentation. Its initial product line consists of proprietary, readily controllable and sterilizeable articulating, robotic-like arms which position and hold endoscopes or other instruments during minimally invasive surgeries. The products have received the acclaim of leading surgeons around the world.

- Pocono Springs - Located in Mount Pocono, PA, the Pocono Spring Company was formed with the help of NEPA Venture Fund in April 1993 to acquire the assets of two, financially-troubled Northeastern Pennsylvania businesses involved in harvesting, bottling and distribution of spring water. Since acquisition, the Company has expanded the business and projects revenues to exceed $10 million in 1995. Pocono Springs strategy is to become an integrated beverage company with strong production and distribution capabilities in select metropolitan locations. Recently, the Company acquired New Age beverage distributorships located in the Philadelphia and Harrisburg/York area. Moreover, Pocono Springs has recently entered into a letter of intent to acquire franchises for two national soft drink brands in the Philadelphia area. 1995 PA employment is expected to be 325, an increase over 1994's employment level of 175.

Alternative Investments

SERS has funded $10 million to one LBO limited partnership fund with a Pennsylvania focus, RR&Z Pennsylvania Fund #1. This LBO fund invests in non-hostile, "friendly," privately negotiated, non-auction deals which are completed with present management in place. The LBO fund focuses on small-to-medium capitalization companies (between $5 and $100 million). SERS believes that this particular focus offers the largest potential returns given the risk levels for these types of investments. In addition, another SERS LBO fund manager, Brentwood Associates, has invested two out of five investments in Pennsylvania and continues to build an investment strategy around its Pennsylvania-based companies.

SERS search for fund managers within Alternative Investments includes a focus on Pennsylvania based companies. SERS recent commitments to this asset class include Charterhouse Equity Partners and Kelso Investment Associates which have made Pennsylvania a part of its focus by investing in Pennsylvania based companies.

The following companies are examples of Pennsylvania investments funded by SERS's alternative investments partnerships:

- Bundy Industries - This company, located in Coraopolis, manufactures baking pans for the commercial baking industry. Bundy will generate approximately $6.3 million in 1995 annual sales and employ 70 Pennsylvania workers.

- Ductmate Industries - Located in Monongahela, this company, along with its subsequent acquisition of Ward Duct Connectors Industries, manufactures proprietary duct connector systems and related hardware for commercial and industrial heating, ventilating and air conditioning (HVAC) systems. Ductmate will generate 1995 annual revenues of approximately $17 million and employ 80 Mon Valley area workers.

- June Broadcasting - This radio broadcasting company was also founded and backed by Murphy & Fauver and owns and operates radio stations. June's chief executive officer is Phil Giordano, an experienced broadcast executive. In May 1993, June acquired for $12 million radio station WNNK-AM & FM "WNNK 104" in Harrisburg. WNNK employs 37 workers and in September 1993, WNNK-AM changed its call letters to WTCY-AM and changes it programming to target the African-American community in Harrisburg. WNNK-FM is the number-one rated radio station in the Harrisburg area.

- Horizon Cellular Telephone Company - This Doylestown-based company, which provides cellular telephone services to the rural area marketplace, is an example of a startup venture conceived by Brentwood Associates, one of SERS's LBO Managers. The company, which was capitalized with $30 million from the Brentwood Fund, presently is now capitalized with $130 million in equity, is an excellent example of the power of leveraged dollars. Horizon will continue to grow its business and build on its Pennsylvania base. Currently, Horizon employs 48 Pennsylvanians with an annual payroll of $3 million.

- J-Pitt Steel - Located in Johnstown, this company was formerly the Bethlehem Steel Corporation's Bar Rod and Wire Division Gautier Mill. J-Pitt's three rolling mills manufacture flat, square, hexagon, round and special shape products in carbon, alloy and leaded steel, which are sold to original equipment manufacturers, cold finish bar producers and steel service centers. The company projects 1995 annual revenues of $33 million. J-Pitt currently employs 131 Pennsylvania workers.

- Thorchem International - This company manufactures products for the construction chemicals industry (i.e. specialty repair and water proof coating, mortars, urethane flooring systems and specialty chemicals). SERS fund manager, Kelso Investment Associates, plans to build via acquisition, a leading global specialty chemicals concern. Kelso has already added workers to the existing manufacturing plant in Bristol, PA by relocating the operating capacity of a plant in Nebraska to that site. Pennsylvania employment is now at 42 with a PA payroll of $1.25 million.

Real Estate Separate Account Pennsylvania Properties

Property	Location	Description	Market Value of SERS % ($ in millions)	Manager
1. Bucks County Business Park	Middletown & Falls Township, Bucks Co.	Five, one-story office flex buildings including warehouse and distribution space	$6.27	JMB Institutional Realty
2. Columbia Mall	Hemlock Township, Bloomsburg	Shopping Mall	$15.0	Heitman Advisory
3. Foster Plaza II-VI	Borough of Greentree, Pittsburgh	Multi-story office buildings	$31.4	JMB Institutional Realty
4. Foster Plaza IX plus land	Borough of Greentree, Pittsburgh	Multi-story office buildings	$4.97	JMB Institutional Realty
5. Greenwood Square	Bensalem Township, Bucks County	Multi-phased flex office facility	$10.0	JMB Institutional Realty
6. Heartland Properties	Reading, Harrisburg, Montgomeryville	Two industrial portfolios warehouse, distribution, and limited mfg. facilities	$24.6	JMB Institutional Realty
7. Lincoln Green Apartments	Philadelphia	360 unit Apt. complex consisting of 288 one bedroom units and 72 two bedroom units	$15.6	JMB Institutional Realty
8. 1818 Market Street	Philadelphia	40 story office tower with a 5 level parking garage	$26.3	Heitman Advisory
9. York Galleria	York	Shopping Mall	$21.4	Heitman Advisory
10. 30 N. Third Street	Harrisburg	10-story office	$21.0	JMB Institutional Realty
Total			$177.0	

SERS Pennsylvania Investments

		Specially Designed PA Portfolios Market Value 12/31/94	Total PA Portfolios Market Value 12/31/94
Stock			
	Emerald - PA Account	$19,624,776.00	$19,624,776.00
	Mellon Equity Associates - PA Account	$40,041,643.00	$40,041,643.00
	Mellon Equity Associates - PA Index	$4,793,603.72	$4,793,603.72
	11 actively managed portfolios (excluding Emerald & Mellon PA Account)		$119,586,441.00
	WFNIA - Equity Index Fund P		$97,455,781.00
	WFNIA - Extended Equity Market Fund		$38,475,986.00
	WFNIA - Equity Growth Fund		$11,018,666.00
		$64,460,022.72	**$330,996,896.72**
Tactical			
	WFNIA - Asset Allocation Fund		**$13,338,260.78**
Fixed			
	Cigna Investments	$1,534,900.27	$1,534,900.27
	Legg Mason		
	commercial mortgages	$305,874,709.12	$305,874,709.12
	residential mortgages	$12,338,886.77	$12,338,886.77
	Other active bond portfolios		$91,462,286.00
		$319,748,496.16	**$411,210,782.16**
Real Estate			
	Pooled Funds (Alex. Brown and Metric specially designed)	$7,102,360.00	$12,565,153.00
	Separate Accounts (net market value)	$177,725,192.00	$177,725,192.00
		$184,827,552.00	**$190,290,345.00**
Venture		**$115,485,298.00**	**$115,485,298.00**
Alternati			
	RR&Z Pennsylvania Fund #1	**$10,074,987.00**	**$10,074,987.00**
Total		**$694,596,355.88**	**$1,071,396,569.66**

SECTION II

Commonwealth of Pennsylvania
State Employes' Retirement System

Investment Performance*
(net of fees)

Asset Class	1994 Total Return through 12/31/94	3 Year Total Return through 12/31/94	5 Year Total Return through 12/31/94	10 Year Total Return through 12/31/94
Domestic Stocks	-0.9 %	6.4 %	9.0 %	13.6 %
Wilshire 5000 Index	*-0.2 %*	*6.6%*	*8.8 %*	*13.8%*
International Stocks	-7.5 %	9.2 %	6.1%	N/A
SERS Custom Int'l Stock Benchmark	*4.5%*	*6.6%*	*0.9%*	*N/A*
Fixed Income	-2.1%	6.0%	8.8%	10.5%
SERS Custom Fixed Income Benchmark	*-4.1%*	*5.0%*	*7.9%*	*10.0%*
Cash	2.6 %	5.7 %	7.5 %	7.9 %
90 day U.S. T-bills	*3.8 %*	*3.6 %*	*5.0 %*	*6.2%*
Tactical Asset Allocation	-0.3%	7.7%	10.9%	N/A
TAA Policy Benchmark	*-1.4%*	*6.3%*	*8.8%*	*N/A*
Real Estate	5.0 %	1.9 %	-0.7 %	3.8 %
Alternative Investments	9.9%	6.0%	4.6%	N/A
Venture Capital	14.8%	9.8%	8.1%	N/A
Total Fund	-1.1%	6.3%	8.3%	11.2%

* *Returns for periods longer than one year are annualized.*

SERS Investments
Actual Statistics for 1980-94

Year End	Market Value	# of Investment Managers	# of Portfolios	# of Consultants	Annual Rate of Return (Total Fund)
1980	$2,556,000,000	3	3	3	5.3%
1981	2,684,000,000	5	6	3	0.9%
1982	3,730,000,000	6	7	4	27.8%
1983	4,396,000,000	14	17	4	13.0%
1984	4,922,000,000	22	24	4	9.4%
1985	5,157,000,000	23	26	3	23.1%
1986	7,120,000,000	30	34	3	15.2%
1987	7,367,000,000	37	42	3	3.3%
1988	8,312,000,000	41	49	3	12.8%
1989	9,758,000,000	47	59	4	17.8%
1990	9,773,000,000	53	65	4	1.0%
1991	11,940,000,000	56	68	4	22.6%
1992	12,407,000,000	66	79	4	7.4%
1993	13,650,000,000	61	80	4	13.2%
1994	13,223,000,000	78	100	4	-1.1%

Prudent Person Investment Standards

The SERS Board of Trustees' investment authority is governed by the "prudent person" standard as set forth in Title 71, Pennsylvania Consolidated Statutes, Section 5931(a). Enactment of the "prudent person" standard in Act 1994-29 and an asset/liability study recently completed by RogersCasey and the SERS Investment Staff are two recent events that helped shape the content of SERS's 1995 Annual Five Year Investment Plan. With prudent person investment authority, SERS is now able to pursue a broader array of investment opportunities that should enhance our ability to achieve competitive rates of return while maintaining risk at acceptable levels. The asset/liability study demonstrated that the prudent application of this expanded investment authority should result in a more efficient portfolio that better serves the needs of SERS.

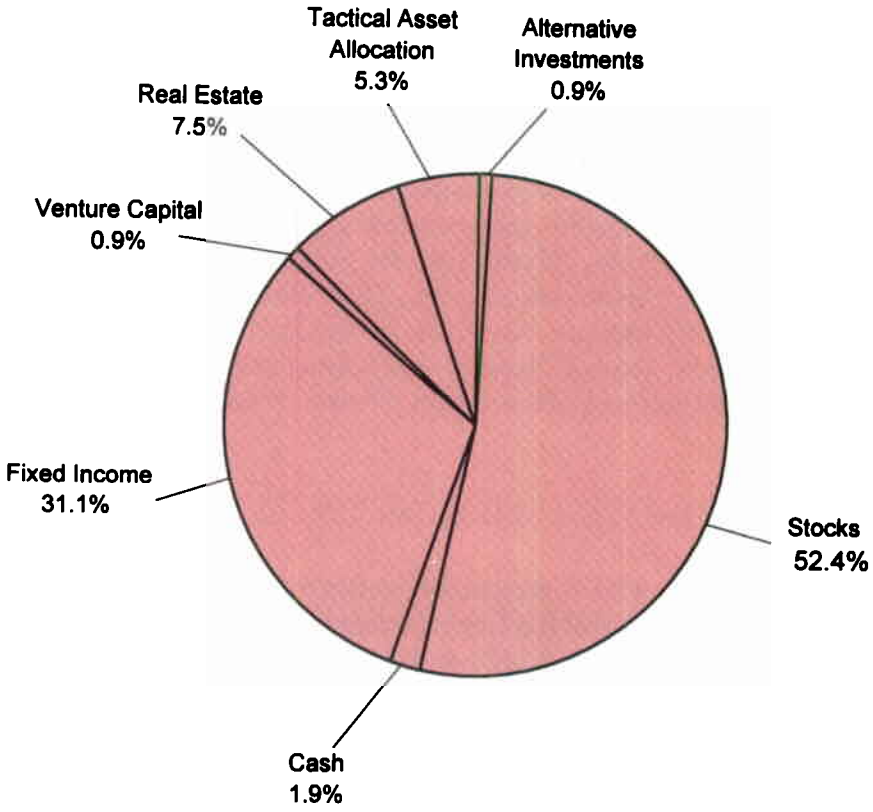
Total Fund Projected Asset Allocation Trend: 1995 through 1999

SERS will implement the Investment Plan over a period of five years. Thus, the Fund's asset allocation strategy will evolve over this timeframe until the long term targets for each asset category are achieved by the end of 1999. This is reflected in the "Asset Allocation Trend" table below.

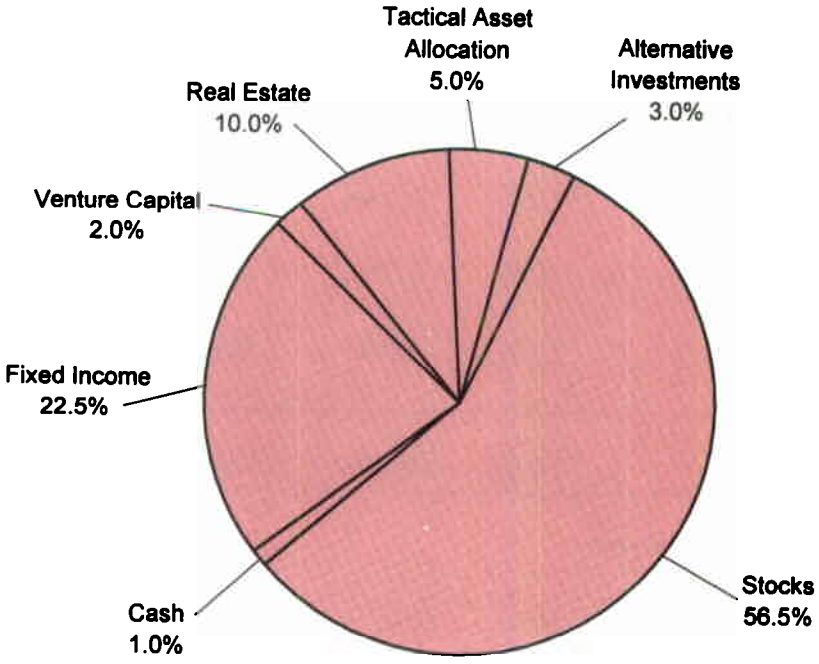
Asset Allocation Trend

1994		1995	1996	1997	1998	1999
52.4%	Stocks	56.5%	56.5%	56.5%	56.5%	56.5%
31.1%	Fixed Income	26.6%	25.3%	24.0%	23.0%	22.5%
5.3%	Tactical Asset Allocation *	5.0%	5.0%	5.0%	5.0%	5.0%
7.5%	Real Estate	8.5%	9.0%	9.5%	9.8%	10.0%
0.9%	Venture Capital	1.2%	1.5%	1.8%	2.0%	2.0%
0.9%	Alternative investments	1.2%	1.7%	2.2%	2.7%	3.0%
1.9%	Cash	1.0%	1.0%	1.0%	1.0%	1.0%
100.0%		100.0%	100.0%	100.0%	100.0%	100.0%

** TAA normal position is 70% stocks and 30% bonds.*



SERS Asset Allocation Year End 1994



Projected SERS Asset Allocation Year End 1999

DECEMBER 31, 1994

Domestic Stocks	($ in millions) Market Value	% of Domestic Stocks	% of Total Stocks	% of Total Fund
Passively Managed Portfolios				
WFNIA - Equity Index Fund (S&P 500)	$2,064.2	36.5%	29.8%	15.6%
WFNIA - Equity Growth Fund	352.0	6.2%	5.1%	2.7%
WFNIA - Extended Equity Market Fund	764.3	13.5%	11.0%	5.8%
Mellon Equity Associates - PA Index	4.8	0.1%	0.1%	0.0%
Domestic Passive Stocks Total	$3,185.3	56.2%	45.9%	24.1%
Actively Managed Portfolios				
Barrow, Hanley, Mewhinney & Strauss	$604.8	10.7%	8.7%	4.6%
Sturdivant & Co.	9.6	0.2%	0.1%	0.1%
Trinity Investment Management Corporation	328.8	5.8%	4.7%	2.5%
Miller, Anderson & Sherrerd	284.1	5.0%	4.1%	2.1%
Provident Investment Counsel	345.0	6.1%	5.0%	2.6%
Zevenbergen Capital	8.3	0.1%	0.1%	0.1%
Mellon Equity Associates - Special Equity	432.1	7.6%	6.2%	3.3%
Mellon Equity Associates - PA	40.0	0.7%	0.6%	0.3%
Dietche & Field Advisors	62.3	1.1%	0.9%	0.5%
Neuberger & Berman	63.0	1.1%	0.9%	0.5%
Pilgrim Baxter & Associates	230.9	4.1%	3.3%	1.7%
Emerald Asset Management - PA	19.6	0.3%	0.3%	0.1%
Provident Investment Counsel - Stellar Fund	49.0	0.9%	0.7%	0.4%
Domestic Active Stocks Total	$2,477.5	43.8%	35.7%	18.7%
Domestic Stocks Total	$5,662.8	100.0%	81.6%	42.8%
International Stocks		% of Int'l Stocks		
BEA Associates - core	$196.5	15.4%	2.8%	1.5%
Miller, Anderson & Sherrerd - core	388.4	30.5%	5.6%	2.9%
Templeton Investment Counsel, Inc. - core	198.6	15.6%	2.9%	1.5%
Morgan Grenfell Investment - European	103.3	8.1%	1.5%	0.8%
Scudder, Stevens & Clark, Inc. - Pacific Basin	116.6	9.1%	1.7%	0.9%
Dunedin Fund Managers - small cap	134.5	10.6%	1.9%	1.0%
Seligman Henderson Co. - small cap	136.2	10.7%	2.0%	1.0%
International Stocks Total	$1,274.1	100.0%	18.4%	9.6%
Domestic and International Stocks Total	$6,936.9		100.0%	52.5%
Fixed Income			% of Total Bonds & Mtgs.	
Passively Managed "Core" Portfolios				
Mellon Bond Associates	$921.4		22.4%	7.0%
Actively Managed "Core" Portfolios				
P. G. Corbin	$8.1		0.2%	0.1%
Miller, Anderson & Sherrerd	1,369.6		33.3%	10.4%
J. P. Morgan	407.2		9.9%	3.1%
Smith Graham & Co.	7.6		0.2%	0.1%
Active Core F I Portfolios Total	$1,792.5		43.6%	13.6%
Core F I Portfolios Total	$2,714.0		66.0%	20.5%
Actively Managed "Specialty" Portfolios				
Cigna Investments	$1.5		0.0%	0.0%
John Hancock	110.1		2.7%	0.8%
W. R. Huff Asset Management	521.4		12.7%	3.9%
Legg Mason Real Estate Advisors	714.6		17.4%	5.4%
Trust Company of the West	47.4		1.2%	0.4%
Active Specialty F I Portfolios Total	$1,395.0		34.0%	10.5%
Fixed Income Total	$4,109.0		100.0%	31.1%
Tactical Asset Allocation		Allocation (Stocks / Bonds / Cash)		
WFNIA - Enhanced 70/30 U.S. TAA	$706.5	40%/60%/0%		5.3%

Numbers may not add due to rounding

Cash	($ in millions) Market Value	% of Total Cash	
Payden & Rygel	$164.3	66.2%	1.2%
PA State Treasury (STIF + Separate Account)	84.0	33.8%	0.6%
Cash Total	$248.3	100.0%	1.9%

Real Estate		% of Total Real Estate	% of Total Fund
Separate Account Portfolios			
LaSalle Partners	$25.8	2.6%	0.2%
Forest Investment Associates	35.3	3.6%	0.3%
Heitman Advisory Corporation	175.3	17.7%	1.3%
JMB - separate account	267.1	27.0%	2.0%
Lowe Enterprises	48.4	4.9%	0.4%
RAI Real Estate Advisors	0.2	0.0%	0.0%
Separate Account Portfolios Total	$552.0	55.8%	4.2%
Pooled Fund Portfolios			
Aetna - 4 pooled funds	$83.4	8.4%	0.6%
Alex Brown	18.2	1.8%	0.1%
Copley CIIF-II	12.2	1.2%	0.1%
Corporate Property Investors	109.7	11.1%	0.8%
Goldman Sachs - Whitehall V & VI	20.1	2.0%	0.2%
Heitman - California Land Venture	10.4	1.1%	0.1%
JMB Group Trust III	38.1	3.9%	0.3%
John Hancock - 2 pooled funds	13.0	1.3%	0.1%
Metric Apartment Fund - 2 pooled funds	46.5	4.7%	0.4%
Prudential - 2 pooled funds	9.4	1.0%	0.1%
PSI III	17.4	1.8%	0.1%
Sentinel Corporation	33.3	3.4%	0.3%
Trust Company of the West - Fund VI	24.7	2.5%	0.2%
Pooled Fund Portfolios Total	$436.5	44.2%	3.3%
Real Estate Total	$988.5	100.0%	7.5%

Venture Capital**		% of Total Venture Capital	
APA/Fostin - PA VC Fund & Fund II	$31.0	26.8%	0.2%
Advent VII	9.9	8.5%	0.1%
Bachow III	0.7	0.6%	0.0%
CEO Venture Fund S & II	6.8	5.9%	0.1%
Edison III	4.7	4.1%	0.0%
Fairview Capital	0.5	0.4%	0.0%
Fostin Capital I & II	7.3	6.3%	0.1%
Grotech Pennsylvania III & IV	8.2	7.1%	0.1%
Healthcare Ventures III	13.6	11.8%	0.1%
Keystone II & IV	12.2	10.5%	0.1%
NEA VI	6.2	5.4%	0.0%
NEPA Venture I & II	7.9	6.8%	0.1%
Pittsburgh Seed Fund	0.6	0.5%	0.0%
Point Venture Partners	0.9	0.8%	0.0%
PNC Venture Group I	1.3	1.1%	0.0%
TDH-II Limited	2.8	2.4%	0.0%
Zero Stage Capital-II	1.1	0.9%	0.0%
Venture Capital Total	$115.5	100.0%	0.9%

* PA State Treasury values are at cost, and do not reflect cash maintained at PA Treasury by SERS investment managers; including SERS manager cash, actual Treasury STIF balance = $297.9 million.

** Venture capital and alternative investment market values are estimates.

Numbers may not add due to rounding

Alternative Investments**	($ in millions) Market Value	% of Total Alter. Inv.	
APAX Partners - 2 European funds	$5.6	4.7%	0.0%
Blackstone II	1.3	1.1%	0.0%
Brentwood Associates Buyout Fund	11.5	9.7%	0.1%
Charterhouse II	16.3	13.7%	0.1%
Code, Hennessy & Simmons I & II	11.4	9.6%	0.1%
Hellman & Friedman II	20.6	17.4%	0.2%
Kelso V	9.1	7.7%	0.1%
Madison Dearborn	6.6	5.5%	0.0%
Murphy & Fauver	3.7	3.1%	0.0%
RR & Z Pennsylvania Fund #1	10.1	8.5%	0.1%
Schroder Ventures UK III	6.5	5.5%	0.0%
Trust Company of the West - Fund V	15.7	13.3%	0.1%
Alternative Investments Total	$118.4	100.0%	0.9%

Total Fund Summary	Market Value	% of Total Fund
Domestic Stocks	**$5,662.8**	**42.8%**
International Stocks	**1,274.1**	**9.6%**
Fixed Income	**4,109.0**	**31.1%**
Cash	**248.3**	**1.9%**
Tactical Asset Allocation	**706.5**	**5.3%**
Real Estate	**988.5**	**7.5%**
Venture Capital	**115.5**	**0.9%**
Alternative Investments	**118.4**	**0.9%**
Total Fund	**$13,222.9**	**100.0%**

** Venture capital and alternative investment market values are estimates.

Revised: February 24, 1995 Numbers may not add due to rounding

Investment Advisors

APA Capital Risque III
New York, NY and Paris, France
(alternative investments)

APA German European Ventures
Munich, Germany
(alternative investments)

Advent VII
Boston, MA
(venture capital)

Aetna Life Insurance Company
Hartford, CT
(real estate)

Arnhold and S. Bleichroeder Capital
New York, NY
(stocks)

APA/Fostin PA Venture Capital Fund
P/A Fund
Philadelphia, PA and Pittsburgh, PA
(venture capital)

Bachow III
Bala Cynwyd, PA
(venture capital)

Barrow, Hanley, Mewhinney & Strauss, Inc.
Dallas, TX
(stocks)

BEA Associates
New York, NY
(stocks)

Blackstone Capital Partners II
New York, NY
(alternative investments)

Brentwood Associates Buyout Fund, L.P.
Los Angeles, CA
(alternative investments)

CEO Venture Fund-S
CEO Venture Fund II
Pittsburgh, PA
(venture capital)

Charterhouse Equity Partners II
New York, NY
(alternative investments)

Cigna Investments, Inc.
Hartford, CT
(fixed income)

Code, Hennessy & Simmons, L.P,
Chicago, IL
(alternative investments)

Copley Real Estate Advisors
Boston, MA
(real estate)

P.G. Corbin Asset Management, Inc.
Philadelphia, PA
(fixed income)

Corporate Property Advisors
New York, NY
(real estate)

Dietche & Field Advisors, Inc.
New York, NY
(stocks)

Dunedin Fund Managers Ltd.
Chicago, IL
(stocks)

Edison III
Lawrenceville, NJ
(venture capital)

Emerald Advisers, Inc.
Lancaster, PA
(stocks)

Fairview Capital
Farmington, CT
(venture capital)

Forest Investment Associates
Atlanta, GA
(real estate)

Fostin Capital Associates
Fostin Capital Associates II/Adams Capital
Pittsburgh, PA
(venture capital)

Goldman Sachs
New York, NY
(real estate)

Investment Advisors (continued)

Grotech Partners III
Grotech Partners IV
Timonium, MD
(venture capital)

John Hancock Mutual Life Insurance Company
Boston, MA
(fixed income)

Hancock Realty Investors Inc.
Boston, MA
(real estate)

Healthcare Ventures III
Edison, NJ
(venture capital)

Heitman/JMB Advisory Corporation
Chicago, IL
(real estate)

Hellman & Friedman Capital Partners II
San Francisco, CA
(alternative investments)

W.R. Huff Asset Management
Morristown, NJ
(fixed income)

Kelso Investment Associates V
New York, NY
(alternative investments)

Keystone Venture II, L.P.
Keystone Ventures IV, L.P.
Philadelphia, PA
(venture capital)

Landmark IV
New York, NY
(alternative investments)

LaSalle Advisors Limited
Baltimore, MD
(real estate)

Legg Mason Real Estate Advisors
Philadelphia, PA
(fixed income)

Lowe Enterprises Inv. Mgmt. Inc.
Los Angeles, CA
(real estate)

Madison Dearborn Capital Partners
Chicago, IL
(alternative investments)

Mellon Bond Associates
Philadelphia, PA
(fixed income)

Mellon Equity Associates
Pittsburgh, PA
(stocks)

Metric Institutional Realty Advisors
San Francisco, CA
(real estate)

Miller, Anderson & Sherrerd
West Conshohocken, PA
(stocks, fixed income)

J.P. Morgan Investment Management, Inc.
New York, NY
(fixed income)

Morgan Grenfell Investment Services Limited
New York, NY
(stocks)

Murphy & Partners, L.P.
New York, NY
(alternative investments)

NEPA Venture Fund, L.P.
NEPA Venture Fund, L.P. II
Bethlehem, PA
(venture capital)

Neuberger & Berman
New York, NY
(stocks)

New Enterprise Associates
NEA VI, L.P.
Baltimore, MD
(venture capital)

Pennsylvania Fund #1
RR&Z Capital Group Inc.
Pittsburgh, PA
(alternative investments)

Pilgrim Baxter & Associates
Wayne, PA
(stocks)

Investment Advisors (continued)

Pittsburgh Seed Fund
Pittsburgh, PA
(venture capital)

PNC Equity Management Corp.
Pittsburgh, PA
(venture capital)

Point Venture Partners
Pittsburgh, PA
(venture capital)

Provident Investment Counsel, Inc.
Provident Investment Counsel Stellar Fund
Pasadena, CA
(stocks)

The Prudential Asset Management Company, Inc.
Short Hills, NJ
(real estate)

PSI Institutional Realty
Glendale, CA
(real estate)

RAI Advisers, Inc.
Radnor, PA
(real estate)

Schroder Venture Fund III
London, England
(alternative investments)

Scudder, Stevens & Clark, Inc.
New York, NY
(stocks)

Seligman Henderson Co.
London, England
(stocks)

Sentinel Corporation
New York, NY
(real estate)

Smith Graham & Company
Houston, TX
(fixed income)

Sprout Capital VII
New York, NY
(venture capital)

Sturdivant & Co., Inc.
Clementon, NJ
(stocks)

TDH II Limited
Radnor, PA
(venture capital)

Templeton Investment Counsel, Inc.
Fort Lauderdale, FL
(stocks)

Trinity Investment Management Corporation
Bellefonte, PA
(stocks)

Trust Company of the West
Los Angeles, (CA)
(fixed income, real estate & alternative inv.)

Wells Fargo Nikko Investment Advisors
San Francisco, CA
(stocks, TAA)

Zero Stage Capital II
West Chester, PA
(venture capital)

Commissions Paid by SERS Stock Managers to Clearing Brokers

Broker	Commission
ABD Securities	$7,326.00
Advest, Inc.	2,268.00
Alex. Brown & Sons, Inc.	6,258.00
Allen & Company, Inc.	4,320.00
Alpha Management Inc.	23,617.00
Autranet	19,236.00
Baird, Robert W. & Co.	2,666.00
Bear Stearns & Co.	199,242.12
Blair, William & Co.	20,736.00
Bridge Trading	12,516.00
Brimberg & Co.	11,707.00
Broadcort Capital Corp.	51,438.60
Brown Brothers Harriman & Co.	7,188.00
Cantor Fitzgerald & Co., Inc.	24,435.00
Capital Institutional Services	81,960.00
Conning & CO/BCC Clearing	7,248.00
Correspondent Serv. Corp.	23,333.00
County Natwest Securities Corp. USA	21,955.00
Cowen & Co.	22,636.00
CS First Boston Corp.	196,422.96
Davis, Mendel & Regenstein, Inc.	6,000.00
Dean Witter Reynolds, Inc.	2,877.00
Dillon Read & Co. Inc.	9,900.00
Deutsche Bank Capital Corp.	34,278.00
Donaldson Lufkin & Jenrette	75,382.00
Ernst & Co.	3,863.00
Ewing Capital, Inc.	22,591.50
Execution Services, Inc.	148,534.76
FNB-Chicago IPA	5,994.00
Factset Data Systems, Inc.	2,400.00
Fahnestock & Co., Inc.	14,725.00
Fidelity Capital Markets	14,619.00
First Albany Corp.	5,105.00
First Manhattan Co.	17,310.00
Furman Selz Mager Dietz & Birney	9,384.00
Gerard Klauer Mattison & Co.	2,394.00
Gibraltar Sec's-Sec. Pac Clearing Corp.	5,502.00
Goldman, Sachs & Co.	150,874.00
Gordon Haskett	7,828.00
Helfant, Lawrence, Inc.	8,792.00
Instinet, Inc.	272,786.48
Invemed Association, Inc.	3,300.00
Investment Performance Service	138,814.50
Investment Technology Group, Inc.	98,923.95
IPS Brokerage Inc/BCC Clearing	38,936.18
ISI Group, Inc.	5,178.00
Janney Montgomery, Scott	19,644.00
Jefferies & Co.	70,832.00
Jones & Associates	8,708.00

Broker	Commissions
Josephthal Lyon & Ross	$5,304.00
Keefe Bruyette & Woods	5,335.00
Keane Securities Co.	9,691.80
Kidder Peabody & Co., Inc.	88,584.50
W. R. Lazard & Laidlaw	34,284.00
Legg Mason Wook Walker, Inc.	3,822.00
Lewco Securities	5,262.00
Lehman Brothers Inc.	86,795.00
Lynch Jones & Ryan	675,423.22
Marolda Nadell Reilly & Co.	2,283.00
Mabon Nugent & Co.	4,739.00
McDonald & Co. Securities, Inc.	4,374.00
Merrill Lynch	54,557.40
Moness Crespi	42,409.50
Montgomery Securities	70,096.00
J. P. Morgan Securities	9,121.00
Morgan Stanley & Co., Inc.	91,222.20
Neuberger & Berman	52,258.50
Newbridge Sec's, Inc. - Equities	4,177.00
Oppenheimer & Co., Inc.	21,692.00
Paine Webber Jackson & Curtis	22,058.00
Piper, Jaffray & Hopwood Inc.	10,656.00
Prudential Securities, Inc.	20,845.00
Pryor Govan Counts & Co., Inc.	9,797.00
Quaker Securities	7,284.50
Quantitative Analysis	33,212.00
RBC Dominion Securities Corp.	2,304.00
Robertson Stephens & Co.	44,762.82
Robinson - Humphrey Co., Inc.	2,760.00
Rochdale Securities Corp.	9,300.00
Rothchild, Inc.	2,016.00
Russell, Frank, Securities Inc.	8,916.00
S E I Funds Evaluation	5,214.00
Salomon Brothers Inc.	98,389.00
Sanford C. Bernstein & Co.	16,036.20
Shields Capital Corp.	6,868.20
Smith Barney/Shearson Inc.	73,559.00
Soundview Financial Group, Inc.	5,454.00
Spear, Leeds & Kellogg	2,100.00
Standard & Poors Securities	50,747.60
Tucker, Anthony & R L Day, Inc.	8,325.00
UBS Securities, Inc.	7,494.00
Warburg, (S.G.), & Co. Inc.	10,290.00
Weeden & Co.	24,779.00
Wheat First Securities, Inc.	10,870.00
Wilshire Associates	38,364.00
York Securities Inc.	136,290.00
Others	22,936.42
Total Commissions	$3,915,043.91

Demographics/Fund Growth

As of December 31, 1994

Ending December 31	Total Members	Active Members	Retirees & Beneficiaries
1994	**194,955**	**114,120**	**80,835**
1993	**192,652**	**111,962**	**80,690**
1992	**190,101**	**109,609**	**80,492**
1991	**181,971**	**105,731**	**76,240**
1990	**185,470**	**111,248**	**74,222**
1989	**182,649**	**109,819**	**72,830**
1988	**180,927**	**109,611**	**71,316**
1987	**179,014**	**109,499**	**69,515**

Sources: SERS Annual Actuarial Reports prepared by Hay/Huggins Company

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Age and Service Profile of Active Members

As of December 31, 1994

Average Age	44.11
Average Years of Service	13.39

Age and Benefit Profile of Retirees

As of December 31, 1994

Average Age	73.60 *
Average Annual Pension	$9,456 **

Source: SERS 1994 Actuarial Report prepared by Hay/Huggins Company

** The average age of superannuation annuitants receiving unreduced retirement benefit; 68.32 is the average age of all retirees (including superannuation, early retirement and disabled), beneficiaries and survivors.*

*** The average annual pension of superannuation annuitants receiving a normal, unreduced retirement benefit; $8,286.88 is the average annual pension for all retirees (including superannuation, early retirement and disabled), beneficiaries and survivors.*

Deferred Compensation Program

Implementation

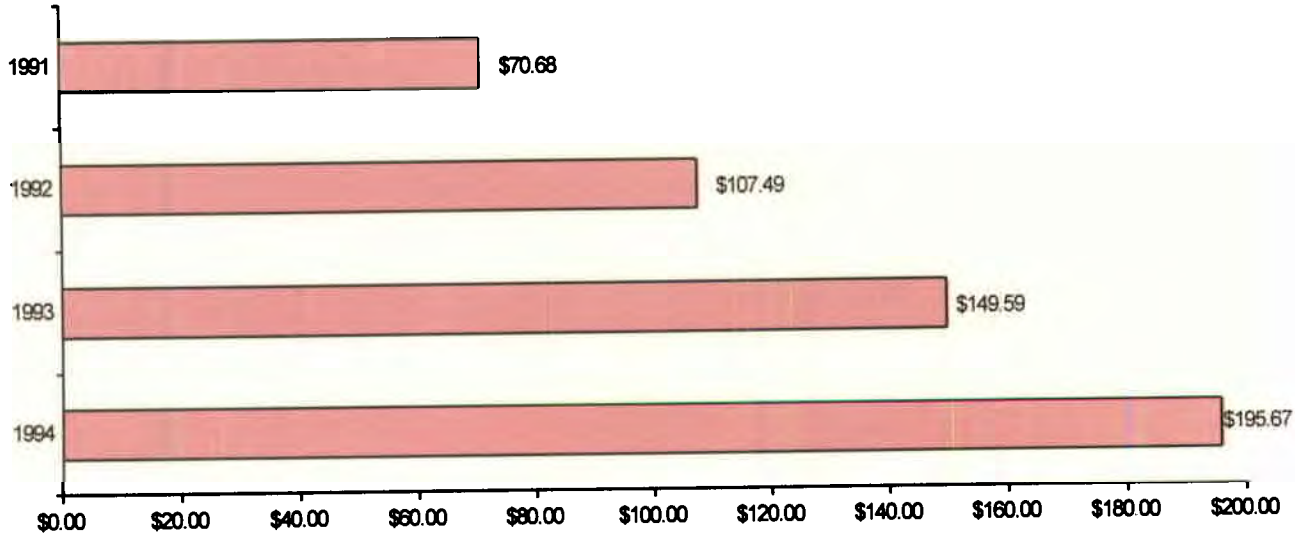
Act 1987-81 assigned to the SERS Board of Trustees the responsibility to establish and monitor an IRC Section 457 Deferred Compensation Program for Commonwealth officers and employes through which members could volunteer to build retirement savings by deferring a portion of their salary to selected investment options.

1994 Highlights

- In 1994, in-house program staff produced and distributed two surveys, one for active participants and one for retired members, polling members on the quality of service and investment instruments.
- Investment products added to the program in 1994: Extended Market Equity Fund; Enhanced Tactical Asset Allocation Fund; Europe, Australia, Far East (EAFE) Equity Index Fund.
- Began a review of stable-value alternatives to the current fixed annuity product.
- Reduced administration fees from $7.50 to $5.00 semi-annually.
- Increased frequency of statements to participants from annually to quarterly.

Growth of the Program

During the period from July 1991 to July 1994 the Deferred Compensation Program assets nearly tripled in value from approximately $70 million to over $195 million. As of January 31, 1995, active participants numbered 20,296, and the total market value of investments was $223,496,370.



Deferred Compensation Program in Millions of Dollars, 1991-1994

Legislation

During the 1994 session of the state Legislature, SERS supported the introduction of House Bill 2652, which, if passed, would have allowed Deferred Compensation Program participants to change their investment choices more frequently than quarterly, as provided in each investment vehicle or contract. This measure did not pass into law, and SERS plans to support introduction of a similar bill in the current session.

SECTION III

COMMONWEALTH OF PENNSYLVANIA
STATE EMPLOYES' RETIREMENT SYSTEM

REPORT OF INDEPENDENT ACCOUNTANTS
ON FINANCIAL STATEMENTS

for the years ended December 31, 1993 and 1992

WITH SUPPLEMENTARY INFORMATION
COMMONWEALTH OF PENNSYLVANIA
STATE EMPLOYES' RETIREMENT SYSTEM

Coopers & Lybrand

certified public accountants

REPORT OF INDEPENDENT ACCOUNTANTS

Board of Trustees
Commonwealth of Pennsylvania
State Employes' Retirement System:

We have audited the statements of net assets available for benefits of the Commonwealth of Pennsylvania State Employes' Retirement System (System) as of December 31, 1993 and 1992 and the related statements of changes in net assets available for benefits for the years then ended. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial status of the Commonwealth of Pennsylvania State Employes' Retirement System as of December 31, 1993 and 1992, and the changes in its financial status for the years then ended in conformity with generally accepted accounting principles.

As explained in Note 2, the financial statements include investments in real estate, mortgage loans and venture capital valued at $1,788,510,000 and $1,741,009,000 as of December 31, 1993 and 1992, respectively (approximately 13% and 14% of net assets as of December 31, 1993 and 1992, respectively), whose values have been estimated by the Board of Trustees, in the absence of readily ascertainable market values. We have reviewed the procedures used in arriving at the estimated values of such investments and have inspected underlying documentation, and, in the circumstances, we believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, those estimated values may differ significantly from the values that would have been used had a ready market for the securities existed, and the differences could be material.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The Supplementary Information is presented in accordance with Statement No. 5 of the Governmental Accounting Standards Board for purposes of additional analysis and is not a required part of the basic financial statements. Such information for the years 1984 and 1988 through 1992 have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole. We previously audited and expressed unqualified opinions on the basic financial statements for the years 1984 and 1988 through 1991. Such information for the years 1985 through 1987 has been subjected to the auditing procedures applied in the audits of the basic financial statements which were audited by other auditors, whose reports thereon expressed unqualified opinions, and, in their opinion, such information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Coopers & Lybrand

One South Market Square
Harrisburg, Pennsylvania
May 13, 1994

COMMONWEALTH OF PENNSYLVANIA
STATE EMPLOYES' RETIREMENT SYSTEM

STATEMENTS OF NET ASSETS AVAILABLE FOR BENEFITS
as of December 31, 1993 and 1992

	1993	1992
	(000's omitted)	
ASSETS		
Investments at fair value:		
United States Government securities	$ 1,946,575	$ 2,175,849
Corporate and foreign bonds and notes	2,092,261	1,690,588
Common and preferred stocks, including collective trust funds	7,222,966	6,320,202
Temporary investments	495,595	372,959
Mortgage loans	807,951	802,046
Real estate	842,333	834,087
Venture capital	138,227	104,876
Total investments	13,545,908	12,300,607
Contributions receivable:		
Employers	84,517	80,192
Employes	3,008	2,031
Accrued investment income receivable	80,321	81,822
Due from brokers	967	
Cash	—	1
Total assets	13,714,721	12,464,653
LIABILITIES		
Accounts payable and accrued expenses	(10,604)	(11,294)
Due to brokers	(3,230)	—
Total liabilities	(13,834)	(11,294)
Contingencies (Note 7)		
NET ASSETS AVAILABLE FOR BENEFITS	$13,700,887	$12,453,359

The accompanying notes are an integral part of the financial statements.

COMMONWEALTH OF PENNSYLVANIA
STATE EMPLOYES' RETIREMENT SYSTEM

STATEMENTS OF CHANGES IN NET ASSETS AVAILABLE FOR BENEFITS
for the years ended December 31, 1993 and 1992

	1993	1992
	(000's omitted)	
ADDITIONS:		
Investment income:		
Net appreciation in fair value of investments	$ 931,494	$ 322,423
Interest	435,411	384,101
Dividends	155,170	123,425
Other	47,827	58,110
	1,569,902	888,059
Less investment expenses	35,532	30,289
	1,534,370	857,770
Contributions:		
Employers	304,122	319,093
Employes	190,360	187,167
Total additions	2,028,852	1,364,030
DEDUCTIONS:		
Benefits and refunds paid to participants	768,797	839,252
Administrative expenses	12,527	11,501
Total deductions	781,324	850,753
Net increase	1,247,528	513,277
Net assets available for benefits at beginning of year	12,453,359	11,940,082
Net assets available for benefits at end of year	$13,700,887	$12,453,359

The accompanying notes are an integral part of the financial statements.

COMMONWEALTH OF PENNSYLVANIA
STATE EMPLOYES' RETIREMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

1. Description of the System:

The State Employes' Retirement System (System) is the administrator of a cost-sharing multiple-employer retirement system established by the Commonwealth of Pennsylvania (Commonwealth) to provide pension benefits for employes of state government and certain independent agencies. At December 31, 1993, there were 115 participating state and independent agencies. The System is considered part of the Commonwealth of Pennsylvania financial reporting entity and is included in the Commonwealth's financial reports as a pension trust fund.

Membership in the System is mandatory for most state employes. Members and employes of the legislature and certain elected persons in the executive branch and certain other employes are not required, but are given the option to participate. At December 31, 1993, System membership consisted of:

Retirees and beneficiaries currently receiving benefits and terminated employes entitled to benefits but not yet receiving them	85,407
Current employes:	
Vested	65,026
Nonvested	46,936
Total members	197,369

The System provides retirement, death, and disability benefits. Retirement benefits vest after 10 years of credited service. Employes who retire at age 60, or with 35 years of service if under age 60, are entitled to a normal annual retirement benefit. Members of the legislature and certain employes classified in hazardous duty positions can retire with full benefits at age 50.

The general annual benefit is 2% of the member's highest three-year average salary times years of service. Members of the legislature who were members of the System before March 1, 1974 are entitled to a benefit of 7.5% of final average salary for each year of legislative service. State police are entitled to a benefit equal to a percentage of their highest annual salary, excluding their year of retirement. The benefit is 75% of salary for 25 or more years of service and 50% of salary for 20-24 years of service.

Covered employes are required to contribute to the System at a rate of 5% of their gross pay. Higher contributions are required of legislators hired prior to March 1, 1974 and judges (18.75% and 7.5% to 10.0% of gross pay, respectively) who are entitled to increased benefits. The contributions are recorded in an individually identified account which is also credited with interest, calculated quarterly to yield 4% per annum, as mandated by statute. Accumulated employe contributions and credited interest, which amounted to $2,170,593,220 and $1,994,567,000 as of December 31, 1993 and 1992, respectively, vest immediately and are returned to the employe upon termination of service if the employe is not eligible for other benefits.

NOTES TO FINANCIAL STATEMENTS, Continued

1. Description of the System, continued:

Participating agency contributions are also mandated by statute and are based upon an actuarially determined percentage of gross pay that is necessary to provide the System with assets sufficient to meet the benefits to be paid to System participants.

According to the retirement code, all obligations of the System will be assumed by the Commonwealth should the System terminate.

2. Significant Accounting Policies:

Basis of Accounting:

The financial statements are prepared using the accrual basis of accounting, under the provisions of Financial Accounting Standards Board No. 35, Accounting and Reporting by Defined Benefit Pension Plans. The System follows Statements No. 3, "Deposits with Financial Institutions, Investments (Including Repurchase Agreements), and Reverse Repurchase Agreements," and No. 5, "Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers," of the Governmental Accounting Standards Board (GASB) for reporting and disclosure purposes.

Valuation of Investments:

The System records its investments at fair value which is determined differently for each investment type. Marketable securities, which consist primarily of debt and equity securities, are stated principally at market value. Securities traded on a national securities exchange are valued at the last reported sales price on the last day of business of each plan year. Securities which were not traded on the last day of the plan year or which were not traded on a national securities exchange are valued by the respective fund manager or other third parties based on similar securities sales. Temporary investments are valued at cost, which approximates market value.

The fair value of the participation units owned by the System in the collective trust funds was based on quoted redemption value on the last business day of the year.

Mortgage loans are valued by the mortgage advisors using a discounted cash flow method. Venture capital pools are stated at fair values as determined principally by the respective valuation committees and accepted by the respective general partners of the venture capital funds. The valuation committees consider various factors including financial condition, operating results and the nature of the investment.

Real estate investments are stated at estimated fair market value based on an appraisal report prepared annually, by an independent real estate appraiser (member of the American Institute of Real Estate Appraisers). This estimated fair market value is determined in accordance with the policies and procedures of the American Institute of Real Estate Appraisers. This estimated fair market value does not necessarily represent the price at which the investment would sell since market prices of real estate investments are determined by negotiation between a willing buyer and seller. As a result, actual sales price may differ from the fair market value estimates. Management believes that this estimated fair market value is a reasonable approximation of market price.

NOTES TO FINANCIAL STATEMENTS, Continued

2. Significant Accounting Policies, continued:

Valuation of Investments, continued:

The System presents in the statements of changes in net assets the net appreciation (depreciation) in the fair value of its investments which consists of the realized gains or losses and the unrealized appreciation (depreciation) on those investments. Realized gains or losses on sales of investments are determined on a specific identification or average cost basis, depending upon the type of investment.

3. Funding Status and Progress:

The amount shown as "pension benefit obligation" is a standardized disclosure measure of the present value of pension benefits, adjusted for the effects of projected salary increases, estimated to be payable in the future as a result of employe service to date. The measure is the actuarial present value of credited projected benefits and is intended, on an ongoing basis, to facilitate the assessment of the System's funding status and progress made in accumulating sufficient assets to pay benefits when due and to allow for appropriate comparison of this data among public employe retirement systems. The pension benefit obligation is calculated based on GASB Statement No. 5 and is independent of the actuarial funding method used to determine contributions to the System as discussed in Note 4.

The pension benefit obligation was determined as part of an actuarial valuation at December 31, 1993 and 1992. Significant actuarial assumptions used include (a) a rate of return on the investment of present and future assets of 9.25% per year compounded annually in 1993 and 1992, (b) projected salary increases of 4% per year compounded annually, attributable to inflation in 1993 and 1992, (c) additional projected salary increases of approximately 2.5% in 1993 and 1992, attributable to merit/promotion, and (d) no post-retirement benefit increases.

The pension benefit obligation at December 31, 1993 and 1992 is as follows:

	1993	1992
	(000's omitted)	
Pension benefit obligation:		
Retirees and beneficiaries currently receiving benefits and terminated employes entitled to benefits but not yet receiving them	$ 4,887,065	$ 4,739,326
Current employes:		
Accumulated employe contributions and credited interest	2,166,958	1,999,511
Employer-financed, vested	4,391,135	4,033,101
Employer-financed, nonvested	408,785	373,891
Total pension benefit obligation	11,853,943	11,145,829
Net assets available for benefits, at fair value	13,700,887	12,453,359
Net assets in excess of pension benefit obligation	$ 1,846,944	$ 1,307,530

NOTES TO FINANCIAL STATEMENTS, Continued

3. Funding Status and Progress, continued:

A comparative ten-year summary of the pension benefit obligation, which has been calculated in conformance with the requirements of GASB Statement No. 5, is presented as supplementary information following the notes to the financial statements. This information is presented for purposes of additional analysis of System progress in accumulating sufficient assets to pay benefits when due. The calculation of the pension benefit obligation under GASB Statement No. 5 differs from the calculation required under Financial Accounting Standards Board (FASB) Statement No. 35 of the actuarial present value of accumulated plan benefits, principally by the consideration of future salary increases and the use of a 9.25% assumed rate of return on investments.

The significant actuarial assumptions used in the valuations of the actuarial present value of accumulated plan benefits under FASB Statement No. 35 as of December 31, 1993 and 1992 are as follows:

Mortality:	
Superannuation (normal retirement) and early retirement	The 1971 Group Annuity Mortality Table
Disability	Modifications of the Federal Civil Service Disability Mortality Table
Assumed rate of return on investments	7.75% and 5.75% in 1993 and 1992, respectively

The assumed rate of return for the year ended 1993 was based on rates consistent with long-term, high quality, investment grade securities. The rate used for the year ended 1992 was consistent with rates used by the Pension Benefit Guaranty Corporation. The System believes rates based on long-term, high quality, investment grade securities provide a more representative assumption of rates which the System will experience.

The accumulated plan benefit information at December 31, 1993 and 1992 is as follows:

	1993	1992
	(000's omitted)	
Actuarial present value of accumulated plan benefits:		
Vested benefits:		
Participants currently receiving payments	$ 5,080,835	$ 6,001,723
Other participants	5,364,864	6,012,343
	10,445,699	12,014,066
Nonvested benefits	185,728	246,519
Total	$10,631,427	$12,260,585

NOTES TO FINANCIAL STATEMENTS, Continued

3. Funding Status and Progress, continued:

The changes in the actuarial present value of accumulated plan benefits for the years ended December 31, 1993 and 1992 are as follows:

	1993	1992
	(000's omitted)	
Actuarial present value of accumulated plan benefits at January 1	$12,260,585	$10,545,321
Increase (decrease) during the year attributable to:		
Passage of time and other causes	614,121	611,811
Changes in interest rate	(2,243,279)	1,103,453
Actuarial present value of accumulated plan benefits at December 31	$10,631,427	$12,260,585

4. Contributions:

The System funding policy provides for periodic member contributions at statutory rates and employer contributions at actuarially determined rates (expressed as a percentage of annual gross pay) that are sufficient to accumulate assets to pay benefits when due. All required contributions were made for the years 1993 and 1992.

Employer contribution rates are determined using the entry age normal actuarial cost method, with amortization of the unfunded actuarial liability and of supplemental annuities arising from cost of living and other adjustments over 20 year periods. These rates are computed based upon actuarial valuations on the Commonwealth's fiscal year of June 30; therefore the employer contribution rates in effect for the System's year end of December 31 reflect a blended average of the rates as calculated. The blended contribution rates were as follows:

	1993	1992
Employer normal cost	9.16%	8.20%
Amortization of unfunded actuarial liability (asset)	(1.07)	.23
Amortization of supplemental annuities	1.01	.96
Total employer cost	9.10%	9.39%

The reduction in total employer cost is a result of the excess actual return on investments over the assumed rate of return on investments. However, the make-up of employer cost has changed as a result of legislation. Current law permits the direct reflection of realistic assumptions, primarily as it relates to investment return and future salary increases, thereby reallocating the components of total employer cost.

NOTES TO FINANCIAL STATEMENTS, Continued

4. Contributions, continued:

Significant actuarial assumptions used to compute contribution requirements are the same as those used to compute the pension benefit obligation, except for the use of an interest rate scale starting at 9.9% in 1991 graded down to 6% after 2015. The graded scale is equivalent to the 9.25% investment return rate used in the projected benefit obligation calculation.

5. Investments:

As provided by statute, the System's Board of Trustees (Board) has exclusive control and management responsibility of System funds and full power to invest the funds. In exercising its fiduciary responsibility to System membership, the Board is governed by the "prudent man" rule, which requires the exercise of due care in establishing investment policy, and has adopted its Statement of Investment Policy to formally document investment objectives and responsibilities. This policy, as well as applicable state law, defines permissible investments of the System, including all investment types held in the portfolio at December 31, 1993 and 1992 and at all times during the years.

The investments of the System at December 31, 1993 and 1992 have been categorized to indicate the level of risk assumed by the System, in accordance with GASB Statement No. 3. In accordance with a contractual relationship between the Commonwealth's Treasury Department and a custodial agent, substantially all securities subject to categorization are held in book entry form in a unique account so as to be identified at all times as the possession of the Commonwealth. All such investments, as well as certain securities held in physical form at the Commonwealth's Treasury Department, the statutory custodian of the Fund, are reflected in Category 1, which is defined as securities insured or registered, or held by the System or its agent in the System's name. GASB Statement No. 3 provides for Category 2 and 3 investments, which reflect a higher risk. The System has no holdings of these types at December 31, 1993 and 1992. Certain investments have not been categorized because securities are not used as evidence of the investment. The investments not categorized include ownership interests in collective trust funds, mortgage loans, real estate and venture capital pools.

NOTES TO FINANCIAL STATEMENTS, Continued

5. Investments, continued:

Summary of Investment Risk	Fair Value 1993	Fair Value 1992
	(000's omitted)	
Category 1:		
United States Government securities	$ 1,303,861	$ 1,632,890
Corporate and foreign bonds and notes	1,855,334	1,430,818
Common and preferred stocks	2,448,696	2,568,364
Mortgage loans	404	801
	5,608,295	5,632,873
Not Categorized:		
Investments held by broker/dealers under reverse repurchase agreements:		
United States Government securities	642,714	542,959
Corporate and foreign bonds and notes	236,927	259,770
Common and preferred stocks	827,198	91,855
Collective trust funds	3,947,072	3,659,983
Temporary investments	495,595	372,959
Mortgage loans	807,547	801,245
Real estate	842,333	834,087
Venture capital	138,227	104,876
	7,937,613	6,667,734
Total investments	$13,545,908	$12,300,607

The System's investments are managed by various fund managers. At December 31, 1993 and 1992, two fund managers accounted for approximately 44% and 43% of the System's total investment portfolio, respectively. This concentration is in accordance with the System's Statement of Investment Policy. Because the System's assets are invested in a variety of financial instruments, the related values as presented in the financial statements are subject to various market fluctuations which include changes in the equity markets, interest rate environment and the general economic conditions.

The System's investments in real estate are concentrated principally in office, industrial, retail, and residential projects. Approximately $208,500,000 and $201,090,000 of the real estate portfolio is located in Pennsylvania as of December 31, 1993 and 1992, respectively. The System's remaining real estate investments are not concentrated in any one geographic area or industry.

5. Investments, continued:

The System participates in a security lending program, whereby certain securities are transferred to an independent broker/dealer in exchange for collateral equal to 102% of the market value of securities on loan (reverse repurchase agreements). As the System represents only one of several Commonwealth agencies participating in the security lending program and, as collateral received by the custodial agent in exchange for System securities is not specifically identifiable by agency, the System does not record the receipt of such collateral or the corresponding liability to return collateral via repurchase of securities under loan. Securities under loan, however, are maintained on the System's financial records and have been classified accordingly in the summary of investment risk. The System has minimized its exposure to credit risk due to broker/dealer default by having the custodial agent determine daily that required collateral meets 102% of the market value of securities on loan. The System has not experienced any losses due to credit risk on security lending activity since implementation of the program.

The System uses a variety of financial instruments including futures, options, and security borrowing arrangements to adjust market exposure. These instruments are integral to the asset allocation, risk management and control systems of the System's investment management strategies and practices. These strategies include holdings of certain foreign debt and equity securities. These holdings were approximately $1 billion and $765 million at December 31, 1993 and 1992, respectively. As a result of these strategies, the System enters into forward exchange contracts primarily as hedges relating to identifiable currency positions. Those instruments are designed to minimize exposure and reduce risk from foreign exchange rate fluctuations. Gains and losses on forward exchange contracts which hedge foreign currency assets are recognized as incurred. Such amounts effectively offset gains and losses on the foreign currency assets which are hedged. The System does not enter into forward contracts on a speculative basis.

At December 31, 1993, the System had contracts maturing through March 1994 to purchase or sell foreign currency as follows:

	(000's omitted)		
	Buy at Spot Rate	Sell at Spot Rate	Net (Payable) Receivable
Deutschemark		$22,638	$(22,638)
French Franc		29,682	(29,682)
Canadian Dollar		8,903	(8,903)
Swedish Kroner		11,543	(11,543)
Italian Lira	$ 6,360		6,360
Other	4,015	13,371	(9,356)
	$10,375	$86,137	$(75,762)

NOTES TO FINANCIAL STATEMENTS, Continued

5. Investments, continued:

At December 31, 1992, the System had contracts maturing through April 8, 1993 to purchase or sell foreign currency as follows:

	(000's omitted)		
	Buy at Spot Rate	Sell at Spot Rate	Net (Payable) Receivable
Deutschemark	$37,382	$ 40,966	$ (3,584)
French Franc	7,625	42,674	(35,049)
Canadian Dollar		13,555	(13,555)
British Pound	9,857	8,493	1,364
Other	6,340	—	6,340
	$61,204	$105,688	$ 44,484

The market values of these contracts were approximately $537 thousand and $2 million at December 31, 1993 and 1992, respectively.

These financial instruments necessarily involve counterparty credit exposure. The policy of the System is to require collateral to the maximum extent possible under normal trading practices. In the event of counterparty default, the System has the right to use the collateral to offset the loss associated with the replacement of the exchange agreements. Specific credit limits have been established for each counterparty and are monitored and adjusted daily. The limits are developed based on the counterparty's creditworthiness, overall industry and other considerations, such as the length and legal structure of the contract, type of collateral advanced, and historical volatility indicators. Credit exposures shown in the above table primarily represent commitments by the System in connection with future, forward, and option contracts.

NOTES TO FINANCIAL STATEMENTS, Continued

5. Investments, continued:

The System's investments, including investments bought, sold, as well as held during the year appreciated (depreciated) in fair value by $931,494,000 and $322,423,000 in 1993 and 1992, respectively, as follows:

	1993	1992
	(000's omitted)	
Fair value as determined by quoted market price:		
United States Government securities	$(41,405)	$ (8,967)
Corporate and foreign bonds and notes	161,968	136,320
Common and preferred stocks, including collective trust funds	827,333	279,441
	947,896	406,794
Fair value estimated by using discounted cash flow, appraised value and valuation committee reports, respectively (Note 2):		
Mortgage loans	(17,110)	(19,811)
Real estate	(22,255)	(55,951)
Venture capital	22,963	(8,609)
	(16,402)	(84,371)
Net appreciation	$931,494	$322,423

The fair value of individual investments that represent 5% or more of the System's net assets available for benefits are as follows:

	1993	1992
	(000's omitted)	
Wells Fargo Nikko Investment Advisors:		
Equity Index Fund P - 131,531,390 units in 1993 and 1992	$2,036,659	$1,851,213
Enhanced U.S. Tactical Asset Allocation Fund - 54,252,737 and 23,502,169 units in 1993 and 1992, respectively	782,039	670,444
Extended Equity Market Fund - 16,340,121 and 14,638,376 units in 1993 and 1992, respectively	789,361	622,805

The Enhanced U.S. Tactical Asset Allocation Fund is diversified among three collective funds: equity, which are invested in Standard & Poor's 500 Companies; long-term fixed income, which are invested in corporate notes and bonds; and short-term cash fund, which are invested in money market instruments.

NOTES TO FINANCIAL STATEMENTS, Continued

6. Income Taxes:

Management believes the System meets the definition of a Governmental Plan and in the System's communications with the Internal Revenue Service (IRS) has been treated as a qualified plan. Therefore, the System has not requested a determination letter from the IRS relating to the status of the System under the Internal Revenue Code.

7. Contingencies:

The System is involved in various lawsuits which, if settled adversely, would not have a material effect on the financial statements in management's opinion. However, the individual cases involve legal issues that, if extended to the entire membership, may result in significant costs to the System. If such an event were to occur, the additional costs would be recovered by the System through adjustments to the employer contribution rate.

8. Early Retirement Incentive Program:

On August 5, 1991, Act 1991-23, was enacted which provided for an early retirement incentive for active members of the System who elected this early retirement option by December 31, 1991. To qualify for the incentive members had to meet certain conditions; if qualified, a member received an additional 10% service credit at retirement. Approximately 6,700 members elected the early retirement option in 1991 resulting in accelerated pension benefits beginning principally in 1992.

SUPPLEMENTARY INFORMATION

COMMONWEALTH OF PENNSYLVANIA
STATE EMPLOYES' RETIREMENT SYSTEM

TEN-YEAR HISTORICAL TREND INFORMATION

Analysis of Funding Progress
(in millions of dollars)
at December 31, 1993

Fiscal Year	(1) Net Assets Available for Benefits*	(2) Pension Benefit Obligation	(3) Percentage Funded (1)/(2)	(4) Unfunded (Assets in Excess of) Pension Benefit Obligation (2)-(1)	(5) Annual Covered Payroll	(6) Unfunded (Assets in Excess of) Pension Benefit Obligation as a Percentage of Annual Covered Payroll (4)/(5)
1984	$ 4,922	$ 6,896	71.4%	$ 1,974	$2,464	80.1%
1985	6,157	6,565	93.8	408	2,427	16.8
1986	7,120	6,984	101.9	(136)	2,518	(5.4)
1987	7,367	7,384	99.8	17	2,663	0.6
1988	8,312	8,257	100.7	(55)	2,779	(2.0)
1989	9,785	8,782	111.4	(1,003)	2,998	(33.5)
1990	9,886	9,536	103.7	(350)	3,197	(10.9)
1991	11,940	10,465	114.1	(1,475)	3,120	(47.3)
1992	12,453	11,146	111.7	(1,307)	3,359	(38.9)
1993	13,701	11,854	115.6	(1,847)	3,546	(52.1)

Analysis of the dollar amounts of net assets available for benefits, pension benefit obligation, and unfunded (assets in excess of) pension benefit obligation in isolation can be misleading. Expressing the net assets available for benefits as a percentage of the pension benefit obligation provides one indication of the System's funding status on a going-concern basis. Analysis of this percentage over time indicates whether the system is becoming financially stronger or weaker. Generally the greater this percentage, the stronger the Plan. Trends in unfunded (assets in excess of) benefit obligation and annual covered payroll are both affected by inflation. Expressing the unfunded (assets in excess of) pension benefit obligation as a percentage of annual covered payroll approximately adjusts for the effects of inflation and aids analysis of the System's progress made in accumulating sufficient assets to pay benefits when due. Generally, where there is an unfunded pension benefit obligation, the smaller this percentage, the stronger the Plan. However, when assets are in excess of pension benefit obligation, the higher the bracketed percentage, the stronger the Plan.

* Reflects investment valuation at fair value (Note 2).

SUPPLEMENTARY INFORMATION

COMMONWEALTH OF PENNSYLVANIA
STATE EMPLOYES' RETIREMENT SYSTEM

TEN-YEAR HISTORICAL TREND INFORMATION

Revenues by Source and Expenses by Type
(in thousands of dollars)
at December 31, 1993

Fiscal Year	Revenues by Source: Employe Contributions	Employer Contributions*	Investment Income**	Total	Employer Contributions as a Percentage of Annual Covered Payroll
1984	$121,929	$439,835	$ 363,365	$ 925,129	17.9%
1985	132,695	460,435	1,105,778	1,698,908	19.0
1986	139,454	407,276	916,323	1,463,053	16.2
1987	147,061	366,463	223,382	736,906	13.8
1988	153,131	382,413	929,778	1,465,322	13.8
1989	164,653	416,513	1,464,707	2,045,873	13.8
1990	175,422	418,655	114,174	708,251	13.1
1991	182,611	381,347	2,154,276	2,718,234	12.2
1992	187,167	319,093	857,770	1,364,030	9.5
1993	190,360	304,122	1,534,370	2,028,852	8.6

* Contributions were made in accordance with actuarially determined contribution requirements.

** Includes net realized and unrealized appreciation or depreciation in fair value of investments and is net of investment expense.

Fiscal Year	Expenses by Type: Benefit Payments	Refunds of Employe Contributions	Administrative Expenses	Total
1984	$384,406	$11,247	$ 4,044	$399,697
1985	447,556	10,680	5,472	463,708
1986	483,603	11,338	4,938	499,879
1987	474,598	10,671	4,811	490,080
1988	504,697	10,446	5,391	520,534
1989	556,324	10,777	6,028	573,129
1990	589,832	9,693	7,400	606,925
1991***	645,936	9,736	8,380	664,052
1992***	829,533	9,719	11,501	850,753
1993	761,993	6,804	12,527	781,324

*** As discussed in Note 8 to the financial statements, 6,700 members elected early retirement in 1991, resulting in accelerated pension benefits principally in 1992.